IC 11

PRACTICE OF GENERAL INSURANCE

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PRACTICE OF GENERAL INSURANCE

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The course is purely meant for the purpose of study of the subject by students appearing for the examinations of Insurance Institute of India and is based on prevailing best industry practices. It is not intended to give interpretations or solutions in case of disputes or matters involving legal arguments.

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PREFACE

Introduction

Insurance business in India is primarily considered under two major categories namely life insurance and general insurance (also known as non-life insurance)

We live and express ourselves through our possessions. We also derive material value from our homes and other possessions. These things fulfil our needs, act as a source of comfort and satisfaction and also enable us to earn money. However, human life has greater value. We treasure them all for what they are and what they can do for us. In the language of economics we call them assets.

These assets can be destroyed or their values affected by various unforeseen events. Life can be ravaged or cut short by disease or death. Our properties can be destroyed by fires or earthquakes or they can simply be taken away by burglars. Even if these events do not occur, the fact remains that we are exposed to the chance of their happening. This situation of uncertainty about the future can make it difficult to plan and conduct any human enterprise.

However, while the future is uncertain, it is possible to predict what will happen to a reasonable extent. Fortunately, only a few of us suffer a certain type of loss at the same point of time.

These two aspects - that loss affects only a few and that its chance of occurrence can be predicted on the basis of past experience - have enabled mankind to create a wonderful institution called insurance. It provides a mechanism by which the economic losses that one would suffer as a result of an event can be shared by all members of a group exposed to the same event. Just as small streams and rivulets go to make the mighty ocean, the small contributions of numerous individuals in a group get collected and pooled into a common fund. The unfortunate few, who suffer a loss, get compensated from this fund created by the contributions of many.

In this book, we shall get introduced to the insurance we will study the markets – both domestic and international, the documentation and processes, individual classes of business, underwriting, rating, claims and insurance accounting. We will have an insight into what it is all about and how it works in various contexts.

CONTENTS

CHAPTER - 1

INTRODUCTION TO GENERAL INSURANCE

Chapter Introduction

In this chapter, you will get introduced to general insurance. You will learn about the origin of insurance as well as the insurance market within and outside India. You will also learn about the different roles within the insurance industry.

We aim to help you understand the framework of the insurance market place and how all the individual roles fit in it.

Learning Outcomes

a) Know about the Indian insurance market.
b) Know about the international insurance market.
c) Understand the roles in insurance.

1. Know about the Indian insurance market. [Learning Outcome a]

1.1 The origin of insurance

- Insurance, as conceived as a method of sharing of losses, embodying the principle of co-operation existed in the early civilisation. There is evidence that during the Aryan civilisation, loss of profits in crafts industry was insured against by the village co-operatives in India. Similarly, contracts safeguarding risks of transport by sea or land were in existence under the auspices of traders' guilds and unions.

- Insurance understood as a technique providing protection against the fortuitous events for a consideration had its origin in the *"bottomry bonds"* which were issued by the Mediterranean merchants as early as fourth century B.C.

- A bottomry loan was an advance of money on a ship during the period of voyage. The loan was repayable with the agreed rate of interest, on arrival of the ship safely at destination; if the ship was lost during the voyage, the obligation to repay the loan was extinguished. The interest payable constituted a sort of premium for the risk of total loss. Similar loans were granted on the security of cargo and were called *"respondentia bonds"*.

- References to similar practices are also found in "Manab Dharma Shastra" (Code of Manu) which contained rules for "sea-form" contracts which were observed by the traders from Broach and Surat who set sail in Indian-built ships laden with Indian merchandise to Lanka, Egypt and Greece.

- Another fore-runner of insurance was the marine practice of general average whereby losses voluntarily incurred to save the common maritime venture were shared by contributions from all the interests – ship, freight and cargo – saved by the general average act. This practice dates back to 916 B.C., when the Rhodians practised it in their Mediterranean trade, involving transport of goods in rowing boats.

- However, the earliest transactions of insurance as practised today can be traced to the beginning of the fourteenth century in Northern Italy. The Italian merchants, who were engaged in the Mediterranean trade with India via Constantinople and with the European countries by land, originated the practice of breaking up the bottomry bonds into two instruments covering separate transactions – the advance of money which was to be repaid on safe arrival of the ship and a policy of assurance which paid the amount stated, in the event of loss at sea. This, then, was the beginning of marine insurance.

1.2 Indian general insurance market - Historical milestones

1938	Introduction of a comprehensive Act called The Insurance Act, 1938
1939	Insurance Rules were framed for effectuating the Insurance Act
1956	Government of India took over all life insurance companies
1968	The Insurance Act, 1938 was amended to provide for social control, minimum solvency margin & setting-up of Tariff Advisory Committee (TAC)
1971	The General Insurance (Emergency Provisions) Act was passed & Government of India took over management of general insurance business, pending nationalisation
1972	General Insurance Business (Nationalisation) Act was passed
1973	General Insurance Corporation of India (GIC) came into existence as a Government Company. A year later 107 insurers practicing general insurance business were grouped and merged to form four subsidiaries of GIC namely: (1) National Insurance Company Ltd. (2) The New India Assurance Company Ltd., (3) The Oriental Fire & General Insurance Company Ltd (4) United India Fire & General Insurance Company Ltd
1991	Introduction of Public Liability Insurance Act 1991 and Public Liability Insurance Rules 1991

1994	The Malhotra Committee (set up by Govt. in 1993 under chairmanship of Shri R. N. Malhotra, former Governor of RBI, to examine potential reforms that could be undertaken in the insurance sector and complement them with reforms initiated in other sectors) submitted its report in January 1994 and recommended establishment of a strong and effective insurance regulatory authority.
1998	Insurance Ombudsman Redressal of Public Grievances Rules 1998, issued.
1999	Based on the Malhotra Committee Report the Insurance Regulatory and Development Authority (IRDA) Act, 1999 was passed in December 1999 and The Insurance Regulatory and Development Authority (IRDA) was established to regulate, promote and ensure orderly growth of the insurance and reinsurance business.
2001	In addition to the existing Government insurance companies, private sector companies were licensed by IRDA to conduct general insurance business,
2002	General Insurance Business (Nationalisation) Amendment Act, 2002.The important amendment was that the subsidiaries of GIC were restructured as independent companies and GIC was converted into a national reinsurer.
2003	This year witnessed the introduction of broker for the first time in Indian insurance market.

It is important to stress here that the insurance market is very similar to any other commercial market. The following grid illustrates the point.

Products	**Makers / Sellers**	**Suppliers / Distributors**	**Buyers**
Consumer Goods	Manufacturers	Retailers	Customers
Insurance Products & Services	Insurers	Insurance Agents and Brokers	People seeking protection

Definition

a) **Insured**: name given to any person or organisation who buys an insurance policy by paying premium for insurance protection
b) **Intermediaries**: people or organisations who sell insurance for insurers - bringing together those who offer insurance protection and those who want to buy it
c) **Insurer**: organisations that offer and provide the capital for insurance protection

Test Yourself 1

Question 1

When did General Insurance Corporation of India (GIC) commence business operations?

A. 1970
B. 1971
C. 1972
D. 1973

1.3 The structure of Indian general insurance market

- **Insurance Regulatory & Development Authority (IRDA):** Is the Regulatory body established under The Insurance Regulatory & Development Authority Act, 1999 and reports to Ministry of Finance
- **Government Insurance Companies:** Also known as Public Sector Insurers. They are 100% owned by the Government of India and work under the Department of Banking and Insurance, Ministry of Finance. They have an association known as General Insurers' (Public Sector) Association of India (GIPSA), which is headquartered in Delhi.
- **Private Insurance Companies:** These can be either 100% Indian Owned Companies or in joint venture with a foreign insurer; the foreign partner's stake restricted to maximum 26%.
- **Brokers:** These can be either Direct Broker, Reinsurance Broker or Composite Broker (doing both Direct and Reinsurance broking). To be licensed by IRDA as per Broking Regulations.

- **Agents**: To be appointed by Insurers in conformity with training and certification criteria in the IRDA regulations.
- **Loss Assessors:** As required under the Insurance Act all losses above INR. 20,000 are to be surveyed by licensed surveyors. Licenses are issued by IRDA, whereas empanelment is done by Insurance Companies.
- **Training:**
  - IRDA has accredited institutes for training of Agents.
  - Insurance Institute of India (which was previously known as Federation of Insurance Institutes) conducts insurance diploma examinations on same lines as Chartered Insurance Institute, London. Its College of Insurance conducts a variety of training programmes for personnel from insurance industry and other organisations.
  - National Insurance Academy: Established in 1980 with prime objective of training insurance executives and conducting research and development in insurance industry is governed by LIC and GIC of India.

Test Yourself 2

Question 2

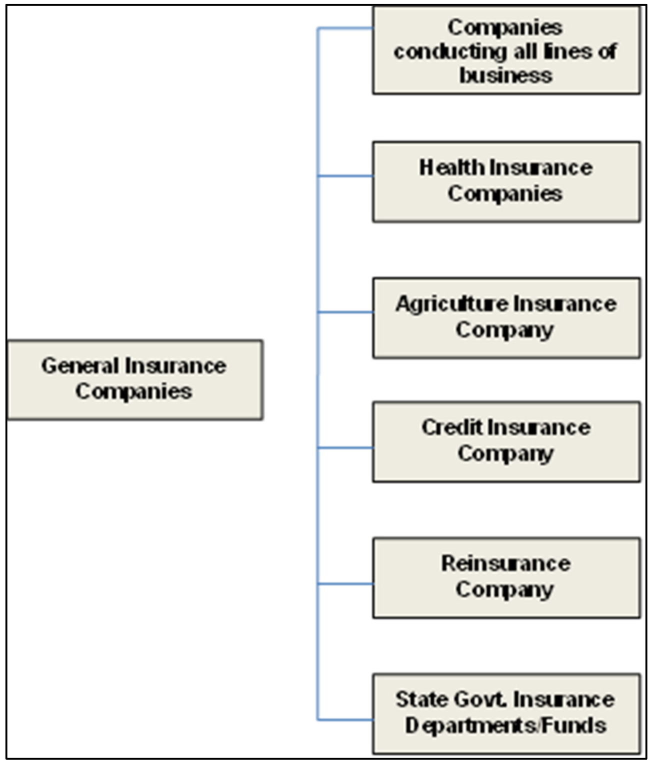
Which of the following is the regulator of insurance business in India?

A. General Insurance Corporation of India
B. Life Insurance Corporation of India
C. Insurance Institute of India
D. IRDA

1.4 Classification of general insurance companies

Apart from their basic classification as Public Sector and Private Sector companies, the Indian General Insurance companies can also be classified into different groups by the lines of business conducted by them:

Diagram 1: Non-life insurance segmentation



a) **Companies conducting all lines of business:** these are both within the Public and Private Sector.

b) **Health insurance companies:** this is the first initiative in the direction of specialisation and has been undertaken by the private sector. Health Insurance has always been seen by the Government as crucial, with the original proposition in 1998 being for the market to open only for health insurance. Companies like Max Bupa Health Insurance, Apollo Munich Health Insurance, Star Health and Allied Insurance Company Limited are some of the companies specialise in and do only health insurance business.

c) **Agriculture insurance company:** the Agriculture Insurance Company of India Ltd. (AICL) opened for business in 2003. It was established in 2002 with the aim of promoting crop insurance business and to protect farmers against crop losses suffered due to natural calamities.

The share capital is provided by GIC, NABARD and the 4 public sector insurers and is headquartered in New Delhi.

d) **Credit insurance company:** the Export Credit Guarantee Corporation of India Limited (ECGC) commenced business in July 1957 and provides export credit insurance support to Indian exporters. It is owned by the Government of India and is the fifth largest credit insurer in the world in terms of coverage of national exports.
ECGC offers

- overseas investment insurance (OII) to Indian companies
- various credit risk insurance covers to exporters against loss in exports
- offers guarantees to banks and financial institutions in respect of exports

e) **Reinsurance Company:** General Insurance Corporation of India (brand name - GIC Re) was originally the holding company of the 4 Public Sector General Insurance Companies. Later in 2000, GIC was approved as an Indian reinsurer with the aim of optimising retention of reinsurance business within the country and developing adequate reinsurance capacity.

GIC manages the Indian insurance pools on behalf of the industry. These pools include:

- Marine Hull Pool
- Terrorism Pool
- Indian Motor Third Party Insurance Pool

GIC has branch offices in London, Dubai and Kuala Lumpur and continues to participate in the share capital of Kenindia Assurance Company Ltd. (Kenya), India International Insurance Private Limited (Singapore) and LIC (Mauritius) Offshore Limited, a joint venture company promoted by LIC of India in Mauritius. It also has a representative office in Moscow, Russia.

As of June, 2011, GIC continues to be the only company licensed by IRDA to conduct reinsurance business. Some foreign reinsurers are interested in operating in India, such as Swiss Re, Munich Re, Scor Re, Hannover Re etc. have been allowed to open some form of liaison /servicing /consulting office within India.

f) **State Govt. Insurance Departments / Funds:** These are the insurance departments of some of the Indian States like Maharashtra, Gujarat, Rajasthan, Kerala. They insure the property and other interests of the respective State Governments.

As of June, 2011, 24 General Insurance and one Reinsurance companies have been licensed by IRDA. The full and upto date list of such companies is available on IRDA website www.irda.gov.in

1.5 Salient features of Indian general insurance market

1. IRDA is the sole authority on all aspects of insurance business-both Life & Non-Life.
2. "Composite" Insurance Company conducting Life & Non-Life Insurance not allowed.
3. "Non-Admitted Insurance" not permitted. i.e. any property situated or to be situated in India has to be necessarily insured with an Indian Insurance Company.
4. "Cash and Carry" market i. e. Cover commences only on Payment of Premium.
5. Retail / direct broking is permitted.
6. Brokers to be licensed by IRDA.
7. Agents to be appointed by Insurers in conformity with IRDA regulations. Agents to be trained by IRDA accredited institutes only.
8. Surveyors (Loss Adjusters) to be licensed by IRDA on the basis of professional qualification, training and experience.
9. **Survey of losses:** Section 64 UM of the Act, provides that no claim in respect of a loss which has occurred in India and requiring to be paid or settled in India equal to or exceeding Rs, 20,000/- on any policy of Insurance shall be admitted for payment or settled by the insurer, unless he has obtained a report on the loss from a person who holds a licence to act as a surveyor or loss assessor.
10. **Reinsurance:** Reinsurance regulation of IRDA aims at maximising retention within the country and developing adequate capacity. Reinsurance programme of each insurer requires prior approval of IRDA at every anniversary.
11. Insurance premium can be collected in instalments only in respect of "Long Term" policies, which are defined in the Act as "policies for a period of more than 12 months".

12. Third Party Administrators (TPA) to be in conformity with IRDA regulations, for management of claims under medical insurance policies.
13. "Ombudsman" Rules provide redressal mechanism for complaints of the policy holders' (both Life & Non-Life) relating to settlement of claims.

Test Yourself 3

Question 3

Which of the following pools is not managed by GIC?

A. Third Party Motor Pool
B. Terrorism Pool
C. Fire Catastrophe Pool
D. Marine Hull Pool

2. Know about the international insurance market [Learning Outcome b]

2.1 Development of insurance in the U.K.

U K, by far, is the largest insurance market in the world and the dynamism with which the UK insurance market developed and is followed by the global market, will be interesting to note.

The practice of marine insurance gradually spread northwards to the Netherlands and then to London, where in the sixteenth century, it got firmly established in the mercantile transactions of Lombard Street which was a centre for commerce.

In 1575 a Chamber of Assurance was established to register policies and settle disputes. This Chamber played an important part during the formative period of marine insurance in London and devised a policy form whose wording is the basis of the modern marine policy.

The early history of marine insurance is closely linked up with the origin and rise of Lloyd's. Shipowners, sea captains and merchants used to congregate in Coffee-houses to deal with their various mercantile transactions and gradually, individual merchants added the business of accepting marine risks to their other lines of activity.

One such Coffee-house made memorable in insurance history was started by Edward Lloyd around 1680 and in this Coffee-house the practice of individual underwriting took shape. Eventually, around the middle of the 18th century these individual underwriters formed themselves into an association with a common subscription.

In 1871 the Lloyd’s Act was framed to set up the Corporation of Lloyd’s. In 1911 Lloyd’s Underwriters were empowered to transact other classes of insurance, commonly referred to as non-marine business. Today Lloyd’s is regarded as a great international insurance centre. Lloyd’s Underwriters operate with giant insurance companies in a spirit of co-operation and healthy competition.

Eventually in 1858 an Association of English and Scottish Fire Offices was formed which came to be known in 1868 as the Fire Offices Committee which, since then, has been the central tariff institution for fire insurance.

The beginning of miscellaneous insurance is directly attributable to the conditions created by the Industrial Revolution in the 19th century.

The Employers’ Liability Act, 1880 which made employers liable under certain circumstances to pay compensation to workers, who were injured at work created the need for insurance protection, and the Employers’ Liability Assurance Corporation Ltd. was founded to provide the requisite protection.

In the early years of the 19th century, there were many explosions of boilers causing heavy damage and bodily injury. Although the Manchester Steam Users Association was formed in 1854 to provide inspection services for boilers, a system of combining insurance protection with inspection service was started by the Steam Boiler Assurance Co. in 1858.

The employers’ liability insurances emphasised the need for third party Claims from third parties against manufacturers for death or bodily injuries due to defective products led to the introduction of products liability insurance.

The first motor vehicle entered the U.K. from the Continent in 1894 and the Law Accident Insurance Society Ltd. started writing motor insurance business from the year 1898 onwards.

Burglary Insurance came to be transacted towards the end of the 20th century.

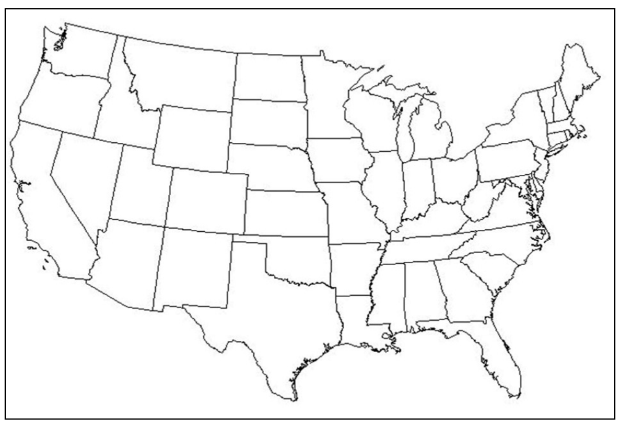
Aviation insurance had its small beginning in 1909-10. The interest in aeronautics was stimulated by World War No.1 and the demand for insurance was felt with the first regular civil aviation service which began in 1919. Aviation business was also transacted by Lloyd's Underwriters right from the start and today specialist aviation syndicates provide substantial insurance facilities to the world market.

The insurance market in the U.K. is highly developed to cater to the international insurance requirements. The market consists of powerful domestic-insurance companies, foreign companies and Lloyd's Underwriters. The market is regulated and controlled by the State through stringent legislation.

2.2 The market shares

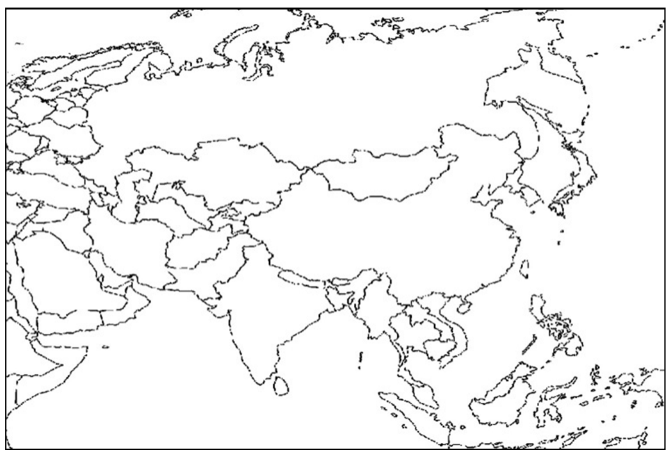
In 2008, the global market had a modest increase (3.4%) when compared to the growth rate of the Indian market. The total value of the whole insurance market was US $ 4.3 trillion of which the non-life sector constituted around 40%.

This was spread across different regions as follows:



North America ....$1,346 Billion

Europe..........................$1,753 Billion



Asia........$933 Billion (The Indian non-life insurance market was around Rupees 36,000 crore i.e around 1% at $ 9 Billion).

What is quite interesting is how the above figures have such a large concentration in just 2 markets:

Markets	Share of global premium	Share of population
US and Japan	40%	7%
Emerging Markets	10%	85%

Indian General Insurance Market - Global Relationship

Geographically, the major markets that we have experience of in India, include the following:

a) London

Whilst most tend to think of it as being synonymous with Lloyd's, there is also a strong non-Lloyd's international market still operating, from the City of London. This is the major port of call for larger and complex Indian risks such as the IT sector or the Energy Sector or the Aviation Sector risks. The London market provides both - capacity and detailed technical experience. However, for the smaller, one-off risks (facultative reinsurance), the disadvantage of the London market is in its high minimum policy premium requirement, with many insurers requiring at least 15,000–20,000 GBP.

b) Singapore

The London market's high minimum premium requirement is a strong incentive for Indian companies to use the Singapore market. The Singapore market has the advantage of being within an Asian mindset and happier to work on the risks that London would see as too small e.g. a typical Indian 5 star hotel requires a 10 million USD Third Party Limit, of which the Indian market can take, say, only 2 million. Singapore's minimum premium requirements are much lower (in the US$ 1000–2000 region) and at the same time it is home to many reinsurers that might have to be otherwise approached in London or elsewhere in Europe e.g. Allianz, Ace, AXA, Liberty, Lloyd's etc.

c) Europe

Europe is also a very strong reinsurance market but without a convenient central location like London. It is a market that the Indian insurer wants to use to provide a competing deal to London.

Munich Re and Swiss Re - the two biggest reinsurance companies in the world had supported the Indian market over many years. Allianz, Zurich, Partner Re, Frankona Re, Liberty are some of the big names among European reinsurers.

d) New York / US

The American insurance market does not have a global presence in proportion to its size. Overall, the American insurers are reluctant to compete on international risks with the European insurers . Besides dealing with the London-based reinsurers, the Indian market uses reinsurers based in Singapore and Hong Kong also. If, however, an Indian risk has a large US component then the American insurers are more likely to be involved.

e) Bermuda

In the 1970's, large corporates began to realise that a more economic way of handling their insurance portfolio was to operate a "captive" insurance company i.e. a wholly owned entity. With its attractive tax regime, Bermuda became the home of choice for such corporates. This was followed by a further boost with the excess liability insurance market in the 1980's and the large capital of the early 1990's to create catastrophe reinsurance companies. Further, capital came in following the terrorist attacks on September 11, 2001 and the hurricanes Ivan, Katrina, Rita and Wilma in the 2004–2005 period .

However, this huge capital comes at a cost and generally the Indian market does not have the size of risks to use Bermuda which tends to look at a minimum attachment point (where the risk starts) of 25 million USD.

f) Australia and Hong Kong

These are little used by the Indian market. At one time, the Australian market was looking to expand into the Asian region but then suffered a huge setback with the collapse of HIH Insurance Company. Hong Kong is, however, still very much aggressive in the Asian market but Hong Kong's main insurers are present in Singapore also and if they are to be contacted, the first approach is normally made there.

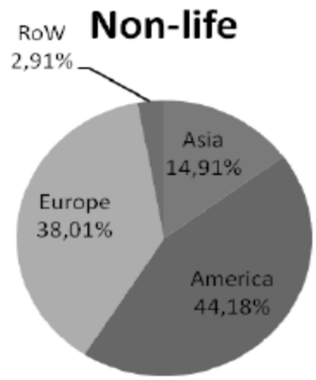
Tip

It is a little known fact that the American Insurance Group (AIG) that most people think of, when asked about US Non-life Insurance was not "born" in America. AIG was actually founded in Shanghai.

2.3 The major non-life insurers of the world

The main insurance buying markets are in Japan and US but the producing markets are a little different, with Europe taking 4 places in the top ten.

As at 2009 the worldwide non-life premium distribution across regions was as under:



Further, while there are 5 US Insurers in the top ten, two of them, Allstate and State Farm are almost exclusively local to the US (The US has around 4000 insurers, of which around 75% are in the non-life sector).

Rank	Company	Revenues (Millions USD)	Country
1	Allianz	142,395	Germany
2	Berkshire Hathaway	107,786	U.S.
3	Munich Re Group	67,515	Germany
4	State Farm Insurance Cos.	61,343	U.S.
5	Tokio Marine Holdings	34,870	Japan
6	Zurich Financial Services	32,349	Switzerland

7	Allstate	29,394	U.S.
8	Liberty Mutual Insurance Group	28,855	U.S.
9	Travelers Cos.	24,477	U.S.
10	Mapfre Group	23,186	Spain

2.4 The major non-life insurers reinsurers

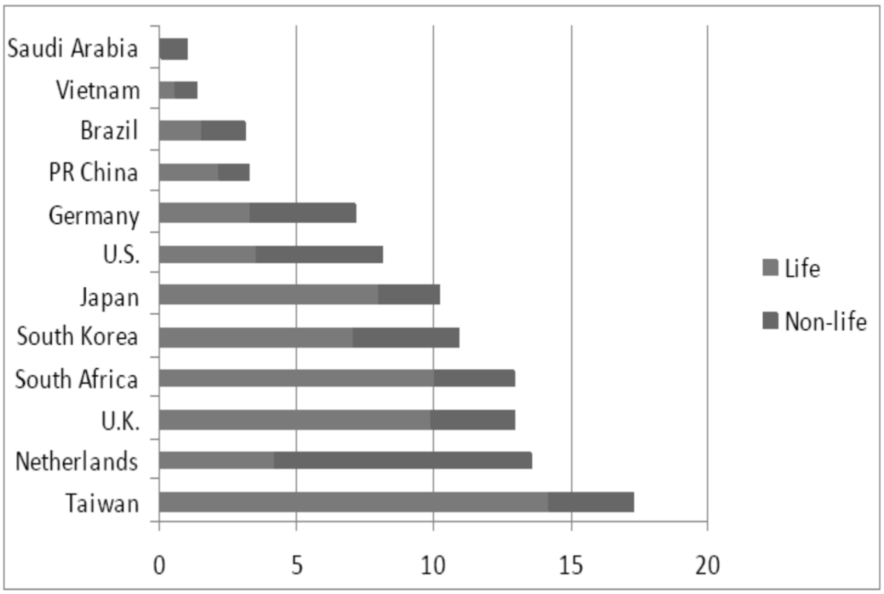
In some respects, the Reinsurance market follows the primary market, with Europe holding 5 of the top 10 places. However, the significant additions are the 3 Reinsurers from Bermuda and this has been prompted by the liberal tax regime in that country aimed, among others, at attracting Reinsurers.

Rank	Company	Net reinsurance premium written (Millions USD)	Country
1	Munich Re Group	30,379.7	Germany
2	Swiss Re Group	23,724.3	Switzerland
3	Berkshire Hathaway Gen Re	11,441.0	U.S.
4	Hanover Re Group	10,653.2	Germany
5	Lloyd's of London	8,588.2	U.K.
6	SCOR	8,551.4	France
7	Transatlantic Holdings Inc.	4,108.1	U.S.
8	Partner Re Ltd.	3,989.4	Bermuda
9	ACE Tempest Reinsurance Ltd.	3,961.0	Bermuda
10	Everest Re Group	3,505.2	Bermuda

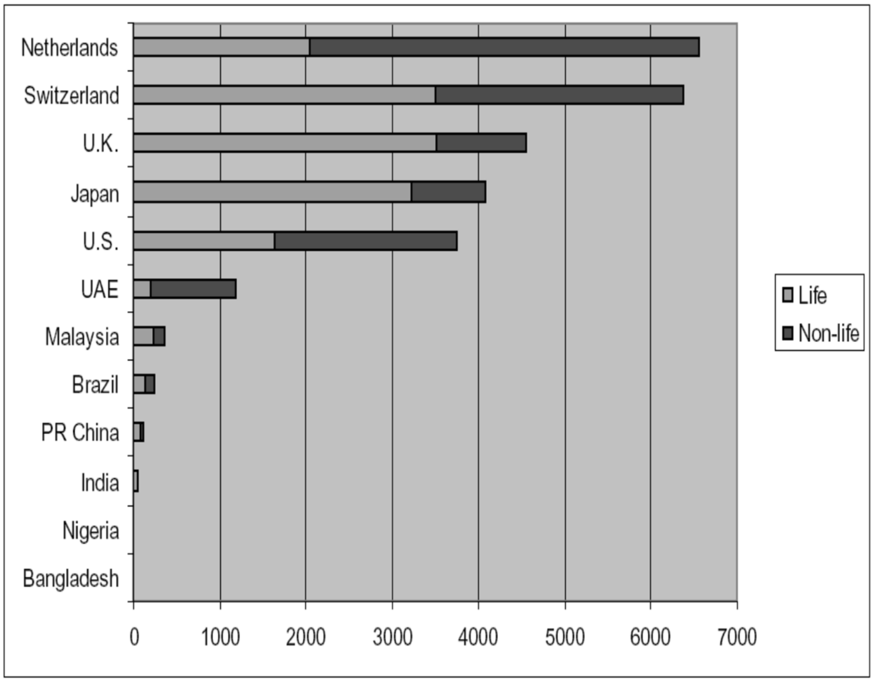
2.5 Insurance penetration and density

These measures help gauge the growth and development potential of insurance markets.

Insurance penetration (premiums in % of GDP, 2009)



Insurance density (premiums per capita in US$, 2009)



Test Yourself 4

Question 4

In terms of revenue which is the biggest non-life insurance company?

A. Allianz
B. Berkshire Hathaway
C. Munich Re Group
D. State Farm Insurance

3. Understand the roles in insurance [Learning Outcome c]

In this section, we will look at the various roles in the insurance industry. The industry is a fast moving one with many major roles and a number of supplementary covers.

We will look at the following roles:

a) **Regulator**

b) **Insurer**, including

- Underwriter
- Claims technician
- Risk engineer / surveyor
- Business developer

c) **Reinsurer and Retrocessionairre**

d) **Insured**, including

- Corporate
- Retail – Individual and SME

e) **Intermediary**, including

- Agent
- Broker
- Reinsurance broker
- TPA
- Lloyd's broker

f) The **ancillary roles**, including

- Valuer
- Actuary
- Loss adjuster
- Insurance lawyer
- Technical consultant
- Insurance software specialist
- Educator

3.1 Regulator – Insurance Regulatory and Development Authority (IRDA)

- **Establishment:** the Insurance Regulatory and Development Authority (IRDA) was constituted by an Act of Parliament in 1999.
- **Insurance regulator:** IRDA is the authority to administer the Insurance Act and to regulate, promote and ensure orderly growth of the insurance industry.
- **Corporate body:** IRDA is a corporate body. The Chairman and other members of the IRDA are appointed by the Government of India.
- **Licensing authority:** IRDA has the authority to issue licences to insurers as well as to intermediaries like agents, brokers, TPAs etc.
- **Industry watchdog:** IRDA has the authority to frame regulations relevant to proper functioning of the industry like adequacy of premium rates, limits on expenses, guidelines on investments, protection of policyholders' rights, solvency limits etc.
- **Guidelines and directions:** IRDA can issue guidelines and directions to insurance companies which are to be followed by them on operational matters.
- IRDA has been entrusted with a number of responsibilities but the key ones include protection of interests of the policy holders, relating to fair pricing, proper policy wording and claim settlement,.

For more information students are advised to refer the IRDA website www.irda.gov.in

3.2 Insurers

The insurer has a number of roles and these have gradually changed over the last 300 years, although the primary role of providing and managing capital has remained unchanged. To manage capital at an operational level insurers have two key roles:

a) that of the underwriter; and
b) that of the claims technician.

Failure of either of these tasks can adversely affect results of an insurance company.

Underwriter

Without the skills of the underwriter, profitable utilisation of capital is not possible. Underwriters decide whether insurance cover is to be granted or not. If cover is to be granted, then the underwriters will decide at what terms, conditions and exceptions it will be granted.

Principal functions of underwriters are:

1. to identify and calculate the risk of loss from policyholders**:** the underwriter decides whether or not to accept a particular risk after securing factual information from/about the applicant, evaluating the information, and deciding on acceptance/declinature.
2. to determine the appropriate price (premium), terms, conditions and exceptions while recording the appropriate classification and rating information.
3. to estimate the potential exposure, check retention and arrange reinsurance where required.
4. to confirm terms, draft the policies to cover the risk and issue the policy.

By performing these four functions, the underwriter increases the possibility of securing a safe and profitable distribution of risk.

Definition

Underwriter

The term "underwriter" was developed in the early days of marine insurance. It was a common practice for individuals seeking insurance for a ship and its cargo, to meet with those desiring to write such insurance in coffee houses (e.g. Edward Lloyd's). A person seeking insurance for his ship and its cargo would bring a piece of paper, describing the ship, its contents, crew, and destination, to the coffee house. The paper would circulate, with each individual who wished to assume some of the obligation, signing his name at the bottom and indicating how much exposure he was willing to assume. An agreed-upon rate and terms were also included in the paper. Since these people signed their names **under** the description of the risk, they became known as **underwriters**.

Underwriting Examples

a) health insurer's underwriter may consider the following aspects in a proposal before deciding on the risk:

- age
- family history
- lifestyle
- current health

b) property insurer's underwriter may consider the following aspects in a proposal before deciding on the risk:

- causes of loss to which property is exposed e.g. flood, fire, earthquake, etc.
- quality of construction
- occupation
- safeguards taken by the applicant

Case and portfolio underwriting

It is also important to point out that the underwriter works at both ends of the spectrum:

- individual case underwriting looking at a specific case
- portfolio underwriting , where he reviews the performance of the total portfolio of a prospect e.g. Fire, Liability, Marine, etc

Today's Debate : Is Underwriting a Science or an Art

In relatively recent times, underwriters prided themselves on having very little formalised information, relying on their own experience and "gut feel" – they saw it almost exclusively as an art. However, technology has advanced so much towards end of the last century that underwriting is much closer to a science.

There is much greater use of sophisticated computer software and such insurance applications are supplemented with reports from loss-control representatives, medical reports, reports from data vendors and actuarial studies.

There is, still, however, a desire to retain some art in a combination of skills, enabling the underwriters to make the best possible judgement.

Risk Engineer

Risk engineers are also known as risk surveyors, risk consultants, risk control surveyors or risk control advisers. They may work for the general insurance companies or a professional broker. Their main role is to advise about quality of risk, based on technical knowledge and good practice.

Definition

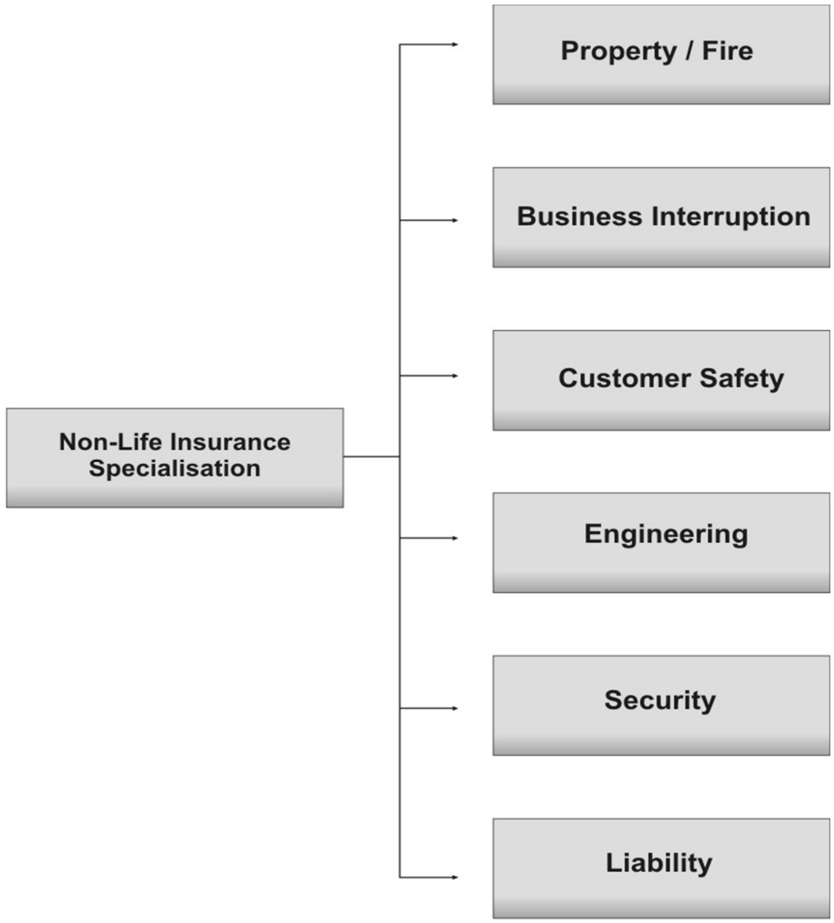
Risk Engineer: A common definition – or probably more correct description - of the Risk Engineer is that of the "Eyes of the Underwriter".

As the Indian market has grown and simultaneously risks have become increasingly complex, there has been a corresponding increase in the requirement that the risk is visited by a Risk Engineer / Surveyor (technical representative) of the insurer.

Traditionally, this was common in property insurances but the practice is now spread across many risks and gradually specialists are available in specific areas such as:

- property/fire and associated risks
- business interruption
- health and safety, for employees and customers
- engineering, structural, electrical installation
- security in crime risks e.g. burglary, theft, transit of attractive goods
- liability

Diagram 2: Non-life insurance specialisation



Example

Specialist engineers / surveyors undertake detailed risk surveys of the property / site to be insured and advise clients and insurance underwriters about appropriate measures to improve quality of the risk. This involves visiting a wide variety of locations and businesses from retail outlets to large-scale petrochemical plants and producing detailed reports, which help inform underwriters about the acceptability and quality of a particular risk.

- Engineer surveyors specialising in property, assess the risks associated with fire, explosions, storms, flooding and malicious damage to a building and / or contents based on the processes and activities that take place and other features specific to the location.
- Engineer surveyors specialising in liability, assess the risks to which employers or other individuals are exposed, based on the processes and activities that take place.

Internal Claims Technician

The claims team members are frequently the unsung heroes of a core insurance operation. The marketers take the glory of increasing premium (albeit now with much greater emphasis on quality of risk) with the underwriters controlling the pricing. However, claims are where the service is most critical. A poor claims performance / service can impact the relationship between the insurers and their clients significantly – one way or the other:

1. Claims handled unfairly and / or slowly can give bad word- of- mouth publicity or even unwelcome press and media attention.
2. Claims overpaid will impact on bottom line (profitability).
3. Omissions to chase recoveries by way of contribution, subrogation, salvage etc. will also adversely affect profitability.
4. Claims handled fairly and efficiently will eventually give a company a solid, dependable reputation.

The claims team, particularly in the complex markets of large property or liability, aviation, marine etc. are frequently the most technical constituent of the operations, needing to understand the client's business and interpret the policy wording accurately.

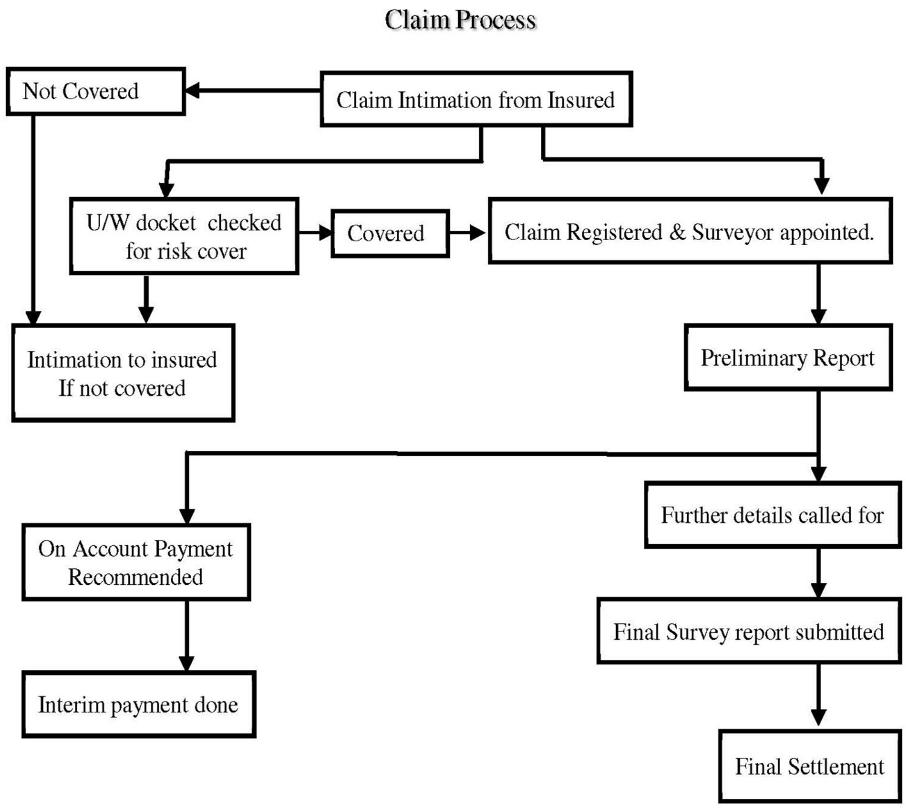
At the same time, the volume / commodity areas are moving into a very slick BPO / KPO operation providing a systematic claims service to commoditised products.

The claims role itself has a number of specialisations, which we can identify to a certain extent by following the flow of the claims process.

There will be a necessity for the senior claims technicians to be well versed on law so that they are able to discuss with their own lawyers and also deal with the lawyers on the other side.

Task	**Activities**
Claims Notification	Acceptance of initial circumstances, possible declinature in straightforward cases, initial decision on reserve
Investigation	a) Investigating the validity of a claim b) Obtaining information, involving expert advice where suitable c) This can involve visiting the policyholder or their property, liaising with the police, lawyers and/or other professional investigators. d) Fine-tuning reserve e) Checking for fraud indicators
Approve / Check	Review claims Decision made on whether claim is covered
Communicate and Negotiate	Advise clients on decision supporting this, where necessary Negotiation skills likely – particularly in larger claims
Settlement and Payment	Liaise internally with finance / accounts department
Recovery	Investigate the areas where the insurer may be able to retrieve moneys from other parties e.g. Contribution – Other insurers Subrogation – Third parties Salvage – Dealers, scrap metal merchants etc.
Closure	a) Complete claim file b) Ensure statistics are up- to- date c) Ensure final payments recorded; and d) Any outstanding reserves removed
Liaison with internal customers	Ensure underwriters receive all relevant facts relating to the risk and / or the portfolio

Diagram 3: Claim process



Loss Adjusters

This is claims team's technical role, usually external, and can also go under the title of 'loss assessors' or 'claims adjusters'.

Adjusters support the insurer in investigating technical claims and while they are normally seen as operating for the insured, they have a reputation of being fair, unbiased and ethical.

Since the claims they handle, are frequently of a very technical nature, a major loss adjusting firm is likely to employ other professionals, such as accountants, engineers, legal officers and the like, recognising the fact that to provide a professional and top class service, a multi-disciplinary approach to claims handling is needed.

The role of the loss adjuster is likely to include the following:

- Checking whether the insurance company is liable under the insurance policy; whether the loss been caused by any of the insured perils under, say, a fire insurance policy or whether any of the exclusions apply under an all risks policy
- Checking on whether any other aspects may affect an insurance company's liability, e.g. operation of conditions, warranties or limits under the insurance policy
- *Damage reclamation services*: range from independent technical advice, through expert guidance on loss limitation opportunities, to specific options to recover and restore damaged property, thereby preventing wastage
- Reporting to the insurers after each and every visit, commenting on the loss reserves and incorporating facts, opinions and recommendations, when appropriate
- Checking the presented claim for accuracy etc. and, after agreeing on any necessary adjustments with the claimant, present the final report to the insurers, recommending settlement
- Checking whether someone else may have been responsible for the loss and, if so, he will obtain statements and physical and photographic evidence to use later in negotiations, when recovery of the insurers' outlay from a third party is sought. Negotiate with product / service providers on time for cost of repairs, for the purpose of making an offer of settlement to the insured
- Satisfy himself that the policyholder has an insurable interest
- Check whether there are any other policies, which may be brought into the apportionment of loss and what they should be.

Test Yourself 5

Question 5

The risk engineer is known as which of the below?

A. The eyes of the insurer
B. The eyes of the underwriter
C. The arm of the underwriter
D. The arm of the claims expert

3.3 Reinsurer

The reinsurer is the next line of defence for the insurance company, wishing to protect its balance sheet. In simple terms, it is insurance of insurance. Through reinsurance; the insurance company taking it, becomes an insured, known in the context of reinsurance, a reinsured or the cedant.

No insurer likes to turn down good business but there are times when the capacity of the insurer would not cope with a major loss. Therefore, rather than declining the business, the insurer will accept it in full and then pass on a portion thereof to another company (reinsurer) – either a share of the risk by way of percentage or as an amount over and above what the insured wishes to retain.

Usually, the insurer will receive an amount of commission for passing this business if done direct, otherwise this will be earned by/shared with the reinsurance broker. The commission is to effectively recompense the insurer for his business development / acquisition and servicing costs.

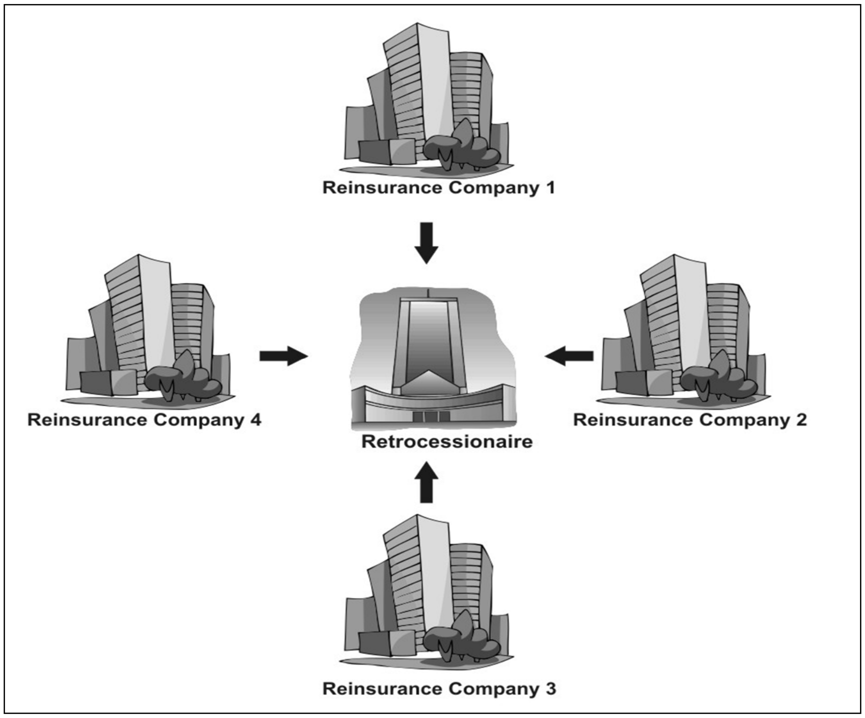
With the exception of the GIC – the national reinsurer, all other reinsurers are based outside India.

Insurers Beware
A critical point is that the contractual relationship is between the insurer and the reinsurer. The insured has NO legal relationship with the reinsurer. If the reinsurer fails, for whatever reason, to support the insurer's claim payment (and this could range from violation of the reinsurance agreement by the insurer to bankruptcy of the reinsurer) then the insurer is responsible for the FULL claim.

Retrocessionaire

Retrocession is reinsuring of reinsurance. The retrocessionaire is the reinsurer of the reinsurance company and the ceding reinsurer is known as the retrocedent. Retrocession is a separate contract and document from the original reinsurance agreement between a primary insurance insurer (as the reinsured) and the original reinsurer. It has no legal relationship with the insurer whatsoever.

Diagram 4: Retrocessionnaire and retrocedants



In the above diagram, reinsurance companies 1, 2, 3 & 4 are all retrocedants.

Definition

A reinsurance company that sells reinsurance is a "retrocessionaire".
A reinsurance company that buys reinsurance is a "retrocedent".

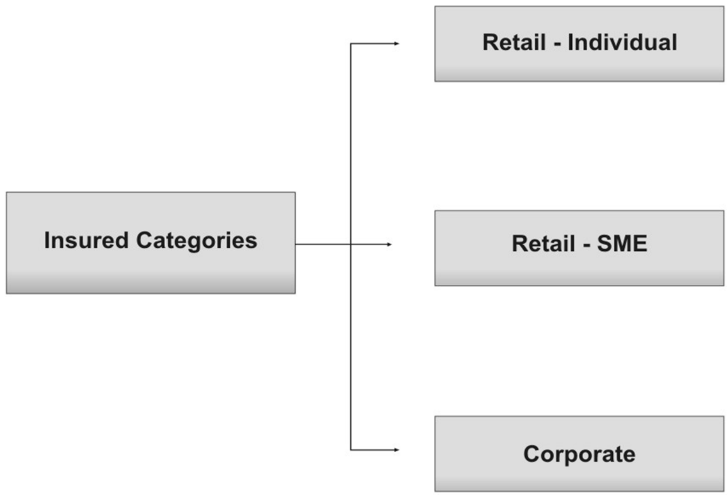
3.4 Insured

Without the insured there will, of course, be no insurance. We have seen that the insured has been relatively easily identifiable in the past – perhaps a merchant who wants marine insurance or a person who wants his family to be looked after in the event of death.

In modern marketing, this is being taken even further into recognisable groups. The aim is to identify niche customers and approach them with the products / solutions relevant to them. In fact, some insurers restrict themselves solely to particular niches – the best examples in India being the health insurers. But in other markets, this could be as specialist as Classic Cars, Bloodstock (Racehorses), Fine Arts, etc.

Let us look at three broad categories of insureds:

Diagram 4: Categories of insured



a) Retail: Individual / Personal

Here we are talking of the individuals in their personal capacity. The major products bought by individuals include:

- Personal Accident, Motor: Third Party Cover is a compulsory insurance in most countries
- Health: this will vary from hospitalisation treatment costs to full medical reimbursement
- Building and Contents: not so common in India yet, compared to other parts of the world, but fast catching up

In the past, these have been purchased either directly from the insurer or via the agency network. However, as in many parts of the industry, technology is making great inroads into the individual market, and one strong belief is that the Indian market will follow examples such as UK, where the individual market is almost totally served remotely by Call Centres or Web selling.

b) Retail: Small and Medium Enterprises (SME)

- Much of it again, is seen as a commoditised market – frequently via a Packaged Product, where risks can be grouped into relatively simple underwriting sectors such as –

  - small shops
  - offices
  - restaurants and cafes
  - hotels

Many insurers are also expanding this into small manufacturing sectors but excluding obvious heavy risks. Underwriting is simplified and terms and conditions are common across most covers.

c) Corporate

The third general sector is the corporate market (ex SMEs). This is almost exclusively the province of the professional insurance brokers in major markets such as US, Europe, Australia, etc.

It can be sub-divided on the basis of sector (for example specialisation in sectors like energy, finance, leisure markets, etc.) or size (for example, mid-size companies, companies having national footprint, MNCs etc.)

Here the classes are big enough to require and warrant individual underwriting and pricing.

3.5 Intermediaries

The Indian market, prior to liberalisation, offered only two areas of intermediation -

a) Development Officer of the insurance company; or
b) Insurance Agent.

However, the situation has changed and now we have insurance brokers, bancassurance and web broking, all at different stages of making their presence felt in the Indian market.

Insurance Broker

This term had been unknown in the Indian market until the relevant regulations – Insurance Regulatory and Development Authority (Insurance Brokers) Regulations, 2002 – came into force and the broking market effectively began to grow from 2003. At the end of 2010, there were over 300 registered brokers licensed by IRDA.

The regulations allow three types of insurance brokers in India:

1. Direct	Acting as an intermediary between the insured and the insurer
2. Reinsurance	Acting as an intermediary between the insurer and the reinsurer
3. Composite	Combination of the above two

Reinsurance Broker

The public sector companies have always needed support from reinsurers abroad and so, there always have been some reinsurance brokers in this market. They have been assisting the insurers in placing their risks abroad through the Facultative and Treaty routes. Most of them have since got themselves registered and obtained licenses from IRDA. There have also been several new entrants. At the last count (end of 2010) there were, besides a number of Direct Brokers:

- 6 Reinsurance Brokers
- 35 Composite Brokers

Agent

The insurance agent was the mainstay of the Indian market up to the end of the last century. Since then, with the growth of the private insurance industry; the other intermediaries have been fast catching up and making their presence felt. This phenomena can be attributed in different degrees to:

- An agent is tied up with only one insurer but a broker can work with any insurer in the market
- other intermediaries are better equipped to use improved technology

- growth of other intermediation areas e.g. bancassurance which has the benefit of established networks

Brokerage and Agency Commissions in India:

IRDA decides the Brokerage and Agency Commission structure, which is currently as below:

	Agency Commission	Brokerage
1. Fire, IAR and engineering insurances		
i. General	10%	12.5%
ii. Risks treated as large risks under para 19(v) of File & Use Guidelines	5%	6.25%
2. Motor insurance business (OD portion), WC/EL & statutory Public Liability Insurance	10%	10%
3. Motor Third Party Insurance	Nil	Nil
4. Marine Hull Insurance	10%	12.5%
5. Marine Cargo Business	15%	17.5%
6. All other businesses	15%	17.5%

(Students are advised to visit IRDA's official website www.irda.gov.in for the latest scale at any given point of time.)

It is worth noting as to who pays remuneration to the agents and brokers:

- Agent – Employed and paid by insurance company,
- Direct Broker – Employed by insured but paid by the insurer,
- Reinsurance Broker – Engaged by insurer and paid by reinsurer,
- Composite Broker – As above for the direct or reinsurance broking activities.

Third Party Administrators (TPA)

Third Party Administrators, referred to as TPAs, have come into the insurance market as intermediaries since 2000.

Insurers appoint TPAs to interact on their behalf with the hospitals. The TPAs negotiate with the hospitals and get them included in the approved list of hospitals into which the policyholder may seek admission. TPAs are required to be companies with a share capital of at least Rs.1 crore. At least one of the directors must be a qualified medical practitioner. One of its officers has to undergo prescribed training and pass a prescribed examination, before it can obtain licence from the IRDA to be a TPA. TPAs get paid by the insurers.

Lloyd's Broker

A further unusual characteristic of the Lloyd's market is that ONLY accredited Lloyd's brokers can place risks in the Lloyd's market on behalf of insureds. There are 176 broking firms working at Lloyd's, many of whom specialise in particular risk categories.

Lloyd's operates an accreditation process for brokers seeking access to the Lloyd's market. Lloyd's performs a careful assessment of all applicant brokers, assessing their reputation and financial standing and investigating the character and suitability of their officers and employees, before making the decision to accredit them. All brokers must satisfy all relevant training and regulatory requirements. Firms receive provisional accreditation for three years before becoming entitled to use the term "Lloyd's Broker". Even an accredited Lloyd's Broker is required to have a formal agreement with a particular syndicate, to be able to place business with that syndicate.

Actuaries

Until recently, actuaries tended to be restricted to the life insurance industry and were very few in numbers. However, as the practice of non-life insurance is continuously evolving, the role of actuaries is growing, with the result that several students now go for courses dedicated to this line.

The actuary is, effectively, a high level mathematician who:

- performs actuarial analysis of correlation between the claims and pricing structures at macro level, going down to the micro level of particular trade / risk classifications
- is experienced in reviewing and analysing insurance operations, claims reserving, underwriting procedures and reinsurance programmes

- provides technical assistance regarding actuarial matters to policy examiners and other technical staff

He or she is involved in the areas of pricing, product design, financial management and corporate planning.

In the Indian market, they also have certain regulatory duties including -

- rendering actuarial advice to the management of the insurer, in particular, in the areas of product design and pricing, insurance contract wording, investments and reinsurance;
- ensuring the solvency of the insurer at all times .

According to the regulations, the actuary is a professional, who has passed the examination conducted by the Institute of Actuaries of India and who is a Fellow of the Institute of Actuaries. He must also possess a certificate of practice, issued by the Institute of Actuaries of India.

3.6 Ancillary roles

One existing aspect of the Indian market is the growth of the ancillary market. Examples of these include (but are not exhaustive) the following:

Professional Valuers: these can be in many areas; with the modern insurance markets using them for valuing buildings, specialised plants, classic cars, works of art etc.

Insurance Lawyers: in the past the Indian market has not had (or needed) specialist insurance lawyers in a big way; however, in developed insurance markets there are not only insurance lawyers but there are lawyers specialising in certain areas such as marine, professional indemnity, IT, etc.

Technical Consultants: presently these form only a small group in the country; but are sure to grow significantly. It comprises technical experts who are not involved in sales. In a growing market, they work on short term technical projects.

Insurance Software Specialists: the Indian information technology (IT) market has been very quick to see the potential here, although much of their work is related to serving international markets.

Many of the major Indian operators, such as Wipro, TCS, L&T Infotech and Infosys have insurance verticals and there are also a number of international insurance majors who use India as a technical support hub e.g. Alliance, Willis, Aviva, etc.

Educational Institutes:
Down the ages, India has been a renowned centre of learning. Takshashila and Nalanda bear testimony to that. That tradition continues to this day and Insurance Education is a shining example.

- At the highest level, there is the Insurance Institute of India (III) in Mumbai that provides a number of professional courses for qualifications from Licentiate through Associateship to Fellowship, embracing the two main streams of insurance - .Life and Non-life.
- The National Insurance Academy (NIA) at Pune offers training in a wide range of subjects. It also offers a two- year post graduate diploma course in insurance.
- Institute of Actuaries of India conducts examinations for actuarial sciences. It offers diplomas at the Fellowship Level.
- There are also a number of educational institutes in different parts of the country, offering insurance courses.
- There are also a number of Agency Training Institutes spread across India.

Test Yourself 6

Question 6

A reinsurance company that buys reinsurance is known as a __________

A. Retrocedant
B. Retrocessionaire
C. None of the above two, as reinsurance companies are not allowed to bye reinsurance

Summary

- The origin of insurance can be traced back to the fourth century B.C. *in the "bottomry bonds"* which were issued by the Mediterranean merchants

- In India, nationalisation of life insurance companies took place in 1956 and that of the general insurance companies in 1972. But in 2000 reforms were initiated by the Government and the insurance sector was liberalised and opened up to private and foreign players.
- During the nationalisation era the non-life insurance landscape was dominated by the four public sector insurers with GIC as their holding company. In 2000, GIC's role was changed to national re-insurer and its four subsidiaries were restructured as independent companies.
- As on June, 2011, there were 24 non-life insurance companies transacting business in India.
- The insurance market comprises a number of role-players like insured, intermediary, insurer, reinsurer, etc., as also the lawyers, consultants, surveyors, etc.
- Reinsurance companies themselves also purchase reinsurance, a practice known as retrocession.
- Insured segment can be further segmented into retail individual, retail SME and corporates.
- Insurance Regulatory and Development Authority (IRDA) is the regulatory body for insurance sector in India.

Some important terms / definitions you have learnt in this chapter

a) Insured, insurer and intermediary
b) Direct, reinsurance, composite intermediaries
c) Retail, SME, corporate
d) Bancassurance
e) Actuary

Answers to Test Yourself

Answer to TY 1

The correct option is **D**

General Insurane Corporation (GIC) commenced business operations in 1973.

Answer to TY 2

The correct option is **D**

IRDA

Answer to TY 3

The correct option is **C**

The Fire Catastrophe Pool does not exist

Answer to TY 4

The correct option is **A**

In terms of revenue Allianz is the biggest non-life insurance company.

Answer to TY 5

The correct option is **B**

The risk engineer is known as ‘the eyes of the underwriter’

Answer to TY 6

The correct option is **A**
A reinsurance company that buys reinsurance is known as a retrocedent.

Self-Examination Questions

Question 1

Which of the below cannot be an intermediary?

A. Insurer
B. Insurance Broker
C. Agent
D. Bank

Question 2

Which is the correct statement?

A. 107 insurers were amalgamated into 4 PSUs
B. 57 insurers were amalgamated into 4 PSUs
C. 145 insurers were amalgamated into 4 PSUs
D. 70 insurers were amalgamated into

Question 3

Which of the following RBI Governors examined the insurance market and made recommendations for reforms?

A. Dr. Manmohan Singh
B. Bimal Jalan
C. R. N. Malhotra
D. C Rangarajan

Question 4

Who does the pricing of insurance products?

A. Surveyor
B. Loss Assessor
C. Risk Engineer
D. Actuary

Question 5

Which of the below companies is a specialist in health insurance?

A. Max Bupa
B. ICICI Lombard
C. Bajaj Allianz
D. HDFC Ergo

Answer to Self-Examination Questions

Answer to SEQ 1

The correct option is **A**.

An insurer cannot be an intermediary. Banks can be intermediaries through Bancassurance / Corporate Agency

Answer to SEQ 2

The correct answer is **A**.

107 insurers were amalgamated into 4 PSUs

Answer to SEQ 3

The correct answer is **C.**

R N Malhotra examined the insurance market and made recommendations for reforms.

Answer to SEQ 4

The correct answer is **D.**

Actuaries do the pricing of insurance products.

Answer to SEQ 5

The correct answer is **A**.

Max Bupa is a specialist in health insurance

CHAPTER 2

POLICY DOCUMENTS AND FORMS

Chapter Introduction

A critical thing that that needs to be remembered is that an insurance document is a legal document. Many of the words and phrases used in an insurance policy document have been tested over the years in the courts of law. While we should now be looking towards plain English form of wording and getting rid of complex words like heretofore, it is important that we try to understand these terms.

In this chapter, we propose to look through the major documents used in the insurance industry, like the policy document, the proposal forms and some other documents. First, we will review the concept of contract before looking at the policy document.

Learning Outcomes

a) Understand the insurance contract.
b) Understand the structure of an insurance policy
c) Learn how to interpret a policy
d) Learn about insurance proposal forms and certificates

1. Understand the insurance contract.
[Learning Outcome a]

1.1 Insurance Contract

A contract of insurance is an agreement whereby

a. one party – the **insurer**,
b. in return for a consideration – the **premium**,
c. undertakes to pay to the other party – the **insured**,
d. a sum of money (or its equivalent) – the **claim** upon the happening of certain specified events.

1.2 Elements of a contract of insurance

The usual rules of contract law govern the contracts of insurance. Specific elements of insurance contract are:

1. Offer and acceptance
2. Consideration
3. Legality (illegal contracts are void) and being capable of performance
4. Agreement (the consent of the parties is necessary for a contract to be enforceable)
5. Contractual capacity (certain persons e.g. minors, cannot be party to a contract)
6. An intention to create a legal relationship
7. No intention to commit fraud

The absence of one or more of these will make the contract void, voidable or unenforceable.

Utmost Good Faith: It is important to remember that contracts of insurance differ from normal commercial contracts, as they are governed by the principle of utmost good faith. Insurance contracts are different from normal contracts because:

1. here, we are not dealing with a physical sale / purchase; and
2. the true facts of the risk are better known to the proposer than to the insurer ; the insurer is relying on the proposer to disclose all material facts about the proposed risk.

Failure on the insured's part to reveal all material facts may make the policy void (i.e. totally ineffective) from inception. However, to activate such avoidance of liability on grounds of non-disclosure, the onus is on the insurer to prove that the:
- undisclosed facts were material.
- facts were within the actual or presumed knowledge of the insured
- facts were not communicated to the insurer

Furthermore, on discovering the non-disclosure, the insurer must exercise the right to repudiate the contract within a reasonable time, for example, if after discovering the non-disclosure, the insurer continues to accept the premium, the insurer would be deemed to have waived the right to repudiate and the contract will be binding, as if there was no non-disclosure. Also, Section 45 of the Insurance Act, pertaining to the indisputability clause, mentions that an insurer cannot dispute a policy claim after 2 years of the existence of the policy, subject to certain conditions.

Test Yourself 1

Question 1

The contractual term for the premium is known as __________

A. Contribution
B. Consideration
C. Commitment
D. Consolidation

2. Understand the structure of an insurance policy [Learning Outcome b]

Components of an insurance policy

Over the last decade or so, policy wordings have changed significantly in looks – particularly in the personal insurances market i.e. Motor Insurance, Householders Insurance, etc. where plain English wordings have begun to take precedence. However, the basic seven components of an insurance policy are still recognisable. These are as follows:

Policy Components
1. Heading
2. Preamble
3. Signature
4. Operative Clause
5. Exceptions
6. Conditions
7. Policy Schedule

2.1 Heading

Every policy document has a heading that includes the name of the insurer and usually their logo / address, together with other contact details e.g. phone numbers, website, etc.

2.2 Preamble

This is generally similar throughout the market. It consists of four main points:

1) The proposal form and any questionnaire are part of the contract and are incorporated within it. Therefore, the insured must be particularly careful when completing these,
2) The Sum Insured.
3) The premium is mentioned.
4) The preamble states that the insurer will provide the cover as agreed.
5) Names of the different parties to the contract – the insured person and the company providing the insurance.

2.3 Signature

Under the preamble or close to it, will be printed the signature of an authorised official of the company. Years ago, this would have been the actual signature. But nowadays, due to increased volumes, even a printed copy is accepted by the courts in cases of dispute.

2.4 Operative Clause

This is a key part of the policy where the actual cover provided is outlined. It is also called the **'insuring clause'** and includes the phrase 'the Company will….'

2.5 Exceptions

This section details what the insurer will not pay for. Whilst ideally the policy holder would like a policy that covers all eventualities, this is impractical in terms of premium, reinsurer agreement, insurer solvency etc.

One alternative would be to define only what is covered – however, this also has impracticalities in that the wording would be too long. The solution is, therefore, to give widest cover possible e.g. *if any of the property insured be accidentally physically lost, destroyed or damaged, other than by an excluded cause……..*

It places the onus on the insurer to be very sure of what to exclude – if it's not excluded, then by definition, it's covered. In plain English format the policy words are often simply mentioned as "we will not pay for........"

Example

Example of "War" exclusion: this policy does not cover loss, destruction or damage, caused by war, invasion, act of foreign enemy, hostilities or warlike operations (whether war be declared or not), civil war, mutiny, civil commotion assuming the proportions of or amounting to a popular rising military rising, rebellion, revolution, insurrection or military or usurped power.

Test Yourself 2

Question 2

The operative clause is also known by which other name?

A. Insuring clause
B. Preamble
C. Signature clause
D. Policy condition

2.6 Conditions

These are as critical to the understanding of the cover, as are the exceptions. They describe to the insured what he or she must do or must not do. Traditionally, conditions appear towards the end of the policy. Some of the common conditions are as follows:

Condition	Comment
Terms	The insured must comply with the terms of the policy.
Alteration to the risk	The insured must notify the insurer should there be a change to the risk..
Claims procedure	This will vary from cover to cover.
Fraud	The benefit of the policy will be forfeited should it be discovered that the claim is in any way fraudulent.
Reasonable care	Insured is to take reasonable care to prevent/minimise loss.
Contribution	Applies if other policies are also in force, covering the same loss.
Cancellation	Will outline the terms to be applied and procedures to be followed, should the company choose to exercise its right to cancel the policy.
Estimates / Declarations	This will detail the procedures to be followed, should the policy premium be based on an estimated figure (e.g. wages / profit).

Express or Implied Conditions: the points mentioned above are known as express conditions, i.e. they are specifically stated as opposed to implied conditions. Implied conditions are those, which are applicable and accepted without being mentioned i.e. being part of the principles of insurance e.g. insurable interest, utmost good faith, etc.

Conditions subsequent to the contract: this is a condition that refers to an act or event that cancels a contractual right e.g. any act of fraud within the claim process on the part of the insured, would immediately cancel the insurer's obligation to continue with the claim.

Conditions precedent to the contract: these are contractual obligations that require one party to the contract, to do something, before the other party to the contract is required to do something, to fulfill its contractual obligation.

Example

For example, if thieves break into the insured's house and steal his or her TV set and laptop then the insured must immediately inform the insurer of the loss as also give them details of the stolen property within a defined number of days of the loss.

2.7 Policy Schedule

The previous components which we have looked at are all pre-printed and so, are not customised / unique to individual insureds. The schedule, however, is the part of the policy document that is specific / unique to each insured person, who has bought the policy. The information that is contained in the Schedule, includes, but is not restricted to:

- Insured's title
- Insured's address
- Nature of the business
- Period of insurance
- Premiums
- Limits of liability
- Policy number
- Any special exclusions / conditions or aspects of cover

Having established that a contract has been entered into, the next task is to determine what it means. The starting point is always to construe the contract in accordance with the ordinary meaning of the words used. The approach is no different when trying to work out the meaning of a contract of insurance.

Getting the meaning right is, therefore, of vital importance to insurers, as they need to be confident that

- they know what risks are to be covered
- the wording adequately reflects that intention

In the context of consumer contracts, the use of plain lucid English is recommended, since the commercial advantage of allowing the policy to clearly set out, what is being covered, is obvious.

However, our history has resulted in the retention of too many complex words like *'heretofore', 'wherewithal'* and *'notwithstanding'* – fortunately, this is changing. The structure of the policy itself can also play a large part in helping to set out clearly, what cover is provided by the policy, and on what conditions.

Most insurance policies are in a printed form, prepared by the insurer. A policy customarily identifies the following:

1. parties, by names	2. subject matter of insurance
3. sum insured or limit of indemnity and the premium payable	4. policy duration
5. contingencies insured against	6. conditions
7. exceptions	

It should also contain provision for a signature or attestation on behalf of the insurer. Details that vary from policy to policy are often grouped in a schedule. The policy may expressly incorporate the proposal form, as completed by the insured.

Endorsements: with the consent of both parties, the policy may be amended from time to time. The insurer then prepares an endorsement for attachment to the policy.

Endorsements are normally used when the terms of an insurance contract are to be varied. Endorsements are attached to the policy document and the two together constitute the evidence of the insurance contract. Endorsements may be issued during the currency of the policy, e.g., when alterations in the risks are to be recorded. They could also be issued at the time of the issue of the policy to provide specific exclusion from the cover or specific extension to include an additional peril. Endorsements are issued on standard forms, or are separately typed, or are written on the policy itself.

The alterations normally required under a policy relate to

- Variations in sum insured (increase / decrease)
- Change of insurable interest by way of sale, mortgage, etc.
- Extension of insurance to cover additional perils.

- Change of risk, e.g. change of construction, or occupancy of the building etc.
- Transfer of property to another location.
- Cancellation of insurance etc.

The insured should make it a point to carefully examine the policy document to confirm that it provides the cover required and take note of any conditions that he must observe. Policies should be stored in a safe place ensuring that they are available when required.

Test Yourself 3

Question 3

Which of the following is a true statement? Fraud is a ______________.

A. Implied Condition
B. Assumed Condition
C. Condition Precedent
D. Condition Subsequent

3. Learn how to interpret a policy [Learning Outcome c]

3.1 Legal Document

Whatever be the cover provided by the policy – a Householders Insurance policy covering Rs. 10 Lakhs of Household Goods or a Professional Indemnity Policy covering an IT major for USD 40 million – one must always remember that we are dealing with a legal document, which should be enforceable in a court of law.

In the event of any dispute between the policyholder and the insurer, the policy will be interpreted by the court.

3.2 Insurers' Responsibility

As with any contract, it is for the parties to a contract of insurance to make their intentions clear in their contract. The courts will not be able to enforce a contract one way or the other, the terms of which are uncertain. Most courts would now see this responsibility being in the hands of the insurer.

If the policy does not correctly represent the agreement, either party may apply to the court to have it rectified. If the parties are not of the same mind i.e. one party intends one thing and the other something else, then there has been no agreement and the policy is ineffective.

3.3 Principles of Construction

The principles of construction in insurance contracts are the same as in the case of other contracts:

1. The construction of a policy of insurance is a matter to be decided by the Court.
2. Where the Court has already decided the meaning of words used on a policy of insurance, the doctrine of precedent will be applied.
3. This means that the same interpretation will be given, should the meaning of the same words be in dispute in a later case.

However, when the words have not been previously interpreted, the Court is guided by certain principles of general application.

3.4 Written Words v/s Printed Words

The written words will be given more effect than the printed words. Most policy wordings are in standardised printed formats for consistency and efficiency. The insurance policy sets out the terms and conditions of the contract in a standard printed form. However, following a change in risk and / or endorsement, the insurer may have added further words and clauses, either in handwriting or in typescript – which take precedent.

Ruling:

1. both the pre-printed and the handwritten words must be taken into consideration.
2. when there is a conflict between the printed and the handwritten clauses, greater consideration will be paid to the handwritten clauses.

The logic is that the written words reflect the latest language and terms selected by the insurer (and accepted by the insured) for expressing the intentions. The pre-printed words, on the other hand, are, broadly speaking, adapted equally to the specific case as also to all other insureds with that type of policy.

The policy must be construed in accordance with the ordinary laws of grammar. The general rule is that the grammatical meaning of the words used in the policy will be adopted.

This may not always be possible e.g. in connection with a policy of marine insurance, the meaning of certain phrases has been understood for many years among shipowners and merchants in a specific sense. Examples of this would include such terms as General Average, Any One Bottom etc.

In case of ambiguity the *contra proferentem* rule will be applied.

Definition

Contra proferentum rule: this rule (which effectively says ***against the offering party)*** states that where contractual language is capable of two alternative interpretations, it will be construed against the insurer who drafted the contract and in favour of the insured, who accepts the wording. This is because the insurer will have chosen the language used and should not be able to benefit from any ambiguity contained within it.

3.5 Policy v/s Proposal:

Where there is an inconsistency between the wording of the policy and that in the proposal or other earlier document/s, the policy is to be regarded as the true intention of the parties, in the absence of valid evidence to the contrary.

Test Yourself 4

Question 4

Which of the following statements is true?

A. Printed word takes precedence over the written word.
B. Written word takes precedence over the printed word.
C. Printed and Written words are treated on the same footing.
D. Printed word takes precedence over the typed word.

3.6 The principal rules of construction are as follows:

One example of bad drafting seen is where a word conveying a broad definition is followed by words of limitation or definition, which introduce words of narrower significance e.g. insurance on a grain dealer's "stock-in-trade consisting of corn, seed, hay, straw, fixtures and utensils in business" does not cover hops for malting. Unless there is a strong underwriting reason for excluding the hops etc. this may result in a badly handled claim, dissatisfied insured and, possibly, poor reputation for the insurer.

Similarly, where a clause framed in general terms and capable of a wider significance (e.g. a declaration that the answers to questions are correct and true, which declaration, together with the proposal, is to be the basis of the contract) is followed by another clause of narrower significance (e.g. a provision avoiding the policy in the event of any fraudulent concealment or untrue statement in the proposal), the second clause is to be regarded as explanatory of the first and limiting its application accordingly.

Example

Shot Gun Death

In Gray v. Barr, 1971 the insured threatened another man with a loaded shotgun and fired into the ceiling to frighten him, and the gun went off a second time in a struggle which ensued. It was held that the death of the other man was not "caused by accident" i.e. a death may be "accidental" in the sense that it is unforeseen and unexpected. But unless it is further caused by accidental means, it does not fall within the scope of a Public Liability policy covering the insured in respect of any sum he may be liable to pay as damages for bodily injury to any person "caused by accident".

3.7 Policy Endorsement

During the period of insurance, there are likely to be times when certain policy details have to be amended. These can arise from a number of incidents including such changes as the following:

- Personal details – title, address, etc.
- Policy details – change in renewal date, amendment in cover, etc.
- Coverage details – increase / decrease in sum insured, addition / deletion of items, etc.
- Cancellation of cover

Such amendments will be effected by means of a policy endorsement , which may call for additional or return premium or in some cases, neither. Such amendments will, of course, only be completed after the underwriting and rating of the changes has been completed.

It must be remembered that the policy is a legal document and the endorsement forms part of this. Now, whilst some of the changes will be straightforward; others could be quite complicated and care needs to be taken over the wording.

3.8 Renewal Documents

Marketing adage: It is much more expensive to obtain a new customer than retain an existing one.

In the past, during the nationalised era, there was a lot less fear over competition and issues such as proactive renewal of a policy was taken much less seriously. However, with a very aggressive public and private insurance market, the development teams are very much aware of the need to ensure policy renewal.

With the smaller clients, the renewals will be automated and a standard increase or decrease will be implemented by the system. It may be that a reporting mechanism will advise the concerned business team of significant changes. What is important, though, is to ensure that the client is geared to renewing his or her policy with little effort.

The renewal document is likely therefore, to include promotional / marketing items to give a positive feel and be very clear in what the insured is expected to pay and what he is receiving for that premium. At the same time, despatch of the renewal notice must be done in such time as to enable the insured to pay promptly.

Renewal Document

The renewal document is likely to consist of the following:

Name and address	With a corporate client, this should also include all subsidiaries, which are crucial to get the interest correct and may raise further questions as to the business.
Policy number	This will remain the same
Contact information of the insurer	
Contact information of the Agent / Broker	
Address of client	Correspondence addresses
Period of insurance	For the forthcoming year
Renewal premium	This may include details of the relevant commission paid to the agent or broker
Declaration reminder	A reminder that the insured must give details of any amended information
64 VB reminder	A reminder that the insurance will not be effective unless the premium is paid before cover is to commence

4. Learn about insurance proposal forms and certificates [Learning Outcome d]

As mentioned earlier, principle of **Utmost Good Faith** is critical as far as insurance is concerned. The insurer must have maximum possible information for the relevant insurance proposal to be able to take a fair decision. To make this as simple and easy for the insured as possible, the insurer has developed proposal forms for virtually all the major classes. Discussed below are the contents of a typical insurance proposal form.

4.1 Insurance proposal form

(a) Generic questions

These are questions, common to all insurance proposal forms:

Name	With a corporate client, this should also include all subsidiaries, which are crucial to get the interest correct and may raise further questions as to the business
Website	This will give additional amount of information about the client
Contact information	
Address	This should include, not just the address of the head office, but also the addresses of major business units of the insured
Business	This should be descriptive of the clients' business with words such as "engineering", "consultant", etc. requiring expansion, so that true occupation can be identified. Certain trades may also require expansion as to the processes involved. Also, certain covers such as liability, are likely to request details of activities and / or processes
Period of insurance	
Insurance history	This will ask who they were insured with earlier and whether they have been declined insurance in the past
Claims experience	This will normally be for the last 3 years – if possible, maybe even for last 5 years. Question will also be asked whether there have been incidents that did not lead to a claim.
Convictions	This may give lead into moral hazard.
Declaration	A signed declaration to confirm that all answers are true and correct

(b) Insurance-specific questions

This section will have questions related to the insurance cover required.

Exposure	The insurer will want to understand more details about the risk to be covered. ➢ **Property insurance:** this will be a description of the subject matter; some details will be high level e.g. buildings (situated at ....) and some details will be very specific e.g. Lenovo X61s laptop serial number .... ➢ **Liability insurance:** this will be the turnover of the business, if products liability then it will be turnover of the relevant product line ➢ **Motor insurance:** details of the vehicles and the drivers
Policy Limits	This will relate to the limits the insured wishes to insure up to ➢ **Property insurance:** this will be the sum insured, with modern covers, it is usually the reinstatement value ➢ **Liability covers:** this will be the limit of indemnity required
Specific Questions	➢ **Liability insurance** : may ask whether hazardous chemicals are handled or whether heat is involved ➢ **Motor insurance:** may ask questions relating to the garaging of the vehicle or whether the vehicle has been modified.

(c) Specific Questionnaires

With a number of covers, there will be a requirement for an additional questionnaire to be completed as the proposal itself will not have the detailed questionnaires (and it is not sensible for the questions to be included on a standard proposal)

Examples of these specific covers relating to individual areas could include the following:

Contractor's All Risks

- Tunnelling
- Bridges and Dams

Liability covers relating to areas such as

- Heat Work Precautions
- Work in High Hazard Environments

Crime covers relating to areas such as

- Armoured car / cash carryings

Marine covers relating to areas such as

- Ship details

4.2 Insurance Certificates

The most common certificate issued within the insurance world is that relating to the existence of the motor insurance. Motor insurance is, without doubt, the major compulsory insurance throughout the world, with all the developed and developing countries requiring some form of **Third Party Insurance for Liability** for bodily injury to other persons. Such compulsory insurance is accompanied by an insistence that a certificate is issued, proving the existence of the cover and policy of insurance. This is required by a number of authorities including the registration authorities and the police.

4.3 Motor Vehicles Act, 1988

In India, the Motor Vehicles Act, 1988 with Chapter XI - Insurance of Motor Vehicles against Third Party Risks section is the relevant one relating to the certificate.

The certificate itself is straightforward with the following being the principal headings:

Identification of the certificate	Policy number and certificate number
Effective date of the insurance	Usually the annual period of the insurance cover
Details of the insured	Name and address
Details of who can drive the vehicle	Usually the insured and any other driver as long as they have a licence and are not disqualified
Details of the vehicle	Registration number, year of manufacture, identification details such as engine number
Purposes as to use	Usually excludes hire or reward, carriage of goods, racing etc.

If the certificate cannot be issued immediately, then a **Cover Note** should be issued for the interim time period – this will be an abbreviated version containing much of the information detailed above but with the Policy Number. The cover note is restricted to a 60 day period and will be accepted by the relevant authorities as a temporary replacement for the certificate of insurance

4.4 Marine Insurance

Within marine insurance, the certificate can effectively take over the role of the insurance policy.

Further, bearing in mind the principle of insurable interest and the fact that the rights under a certificate can be assigned by the seller to the buyer, it is important that there exists only signed ORIGINAL of each document and that the Certificate is TYPED.

Duplicate policies should be boldly printed or stamped as COPY. However, occasionally, Letters of Credit call for a signed DUPLICATE Certificate. A duplicate would stand in law, in place of the original document, in all respects. While one should resist issuing duplicates, in case it becomes unavoidable, it should be stamped in the following manner:

“This policy (or certificate) is issued in original and duplicate, one of which being accomplished, the other to stand null and void.”

It is also important that marine certificates are completed accurate, to ensure that any claims can be handled in an efficient manner with the minimum delay.

The details required are:

Certificate number	This is normally computer generated
Date issued	This is the date when the certificate is completed
Open policy number	This will be given in the policy schedule and must be mentioned in all the certificates issued. The number does not change during the policy period.
Premium	Ensure mention is made of the Gross Cargo and War & SRCC premium, Stamp Duty and Service Charges. Special Discount, if any, in lieu of Agency Commission too could be shown here. Similarly, if Customs Duty is insured, then Duty premium too should be mentioned.
Assured	The name of the company should be inserted. Where a bank or similar organisation requests their interest to be shown, this can be completed in the field. e.g. "The ABC Company & / or the XYZ Bank."
Sum Insured	The insured value should be calculated in accordance with the agreed basis of valuation in the policy, unless agreed otherwise, with the company. Insured value should not exceed the limit of liability any one vessel, aircraft, road or rail conveyance or postal sending. The value should be shown in figures and words, stating the currency e.g. 'Rs 150,000' "One Lakh and Fifty Thousand Rupees."
Voyage from / to and via	Show the name of the overseas vessel (where known); otherwise show the means of transport, for example: 'Vessel', 'Aircraft', 'Road Conveyance', 'Rail Conveyance', 'Post'.
From	Show place of origin, for example 'Warehouse – Birmingham, UK'

To	Show the final destination, for example 'Warehouse – New York, USA'
Via	If known, this should be completed. This is of particular importance if transhipment is involved.
Bill of Lading date	If not known write "sailing on or around……… (date)"
Interest (i.e., subject matter insured) & marks and numbers	Complete with full description of subject matter insured and all shipping marks, including type of packing and numbers of packages plus any other information such as 'Shipped on Deck', 'Special Stowage', 'Full Container Load' (FCL) or 'Group age'. Identification of postal packages may be shown as "fully addressed". Where a Letter of Credit is involved, banks will show the precise words, which they require to be shown on the certificate. The description of the subject matter insured and the marks and numbers should be copied exactly.

Test Yourself 5

Question 5

The Motor Cover note can only be issued for how many days?

A. 15
B. 30
C. 45
D. 60

4.5 Insurance Claim Form

The prime aim of any insurance company has to be to shield the insured from possible losses and pay claims and compensate the insured as per the terms of the policy, when the situation arises. The utmost good faith concept is as important at the time of claims, as it is at the time of issue of policy.

Furthermore, the insurer has to investigate the claim as thoroughly as possible, to ensure that payments are made fairly and equitably. At the same time, it is critical that the insurer collates as much information as possible to build up the claims database.

With both these aims in mind, the insurer will usually request for completion of a claim form, once initial advice of a claim has been received. The format will vary from class to class and from insurer to insurer, but many of the headings will be relatively common across both. The claim form may ask for details as mentioned below.

Common Questions

Name	This information will be used to check whether the interest is correct. This can be particularly important with corporate claims, where there may be a number of subsidiaries. Also likely to be used for filing purposes, whether online or manual.
Business	This is increasingly being captured as part of cross-selling / marketing initiatives generally and will, in any case, be a necessity in certain classes of insurance in the corporate classes to ensure that the underwriting information is consistent
Policy number	To be used for identification purposes
Contact information	This will include telephone details and e-mail etc.
Contact address	Detailed address of the insured / business place
Any other insurance in force	This will be used for those risks where contribution may be a factor – mainly in property insurance

Date (and time) of incident (or discovery of incident)	This will vary with the class – obviously immediate accidents such as Motor or Fire can be defined by the time as well as the date, however with Liability Insurance Claims it may not even be clear which year the incident actually happened (i.e. illness or diseases claim). Such claims may be filed only when the event was discovered.
Location of incident	This will be important for the database and may also be relevant as regards whether the claim is valid, as it may happen outside the geographical limits of the policy
Circumstances of the incident	Details of what led to the incident
Reporting to other authorities	This will normally relate to theft and the like, where there will be a requirement to report to authorities such as the police
Information on the items lost or damage	This will relate to liability insurance as well as property
Declaration	A signed declaration to confirm that all answers are true and correct

Summary

- An insurance contract is a legal document and has all the elements of a valid contract.
- For most classes, the policy structure is standard and divided into 7 components.
- An insurance proposal form includes general questions, insurance related questions and specific questions.
- Claim forms are used for both; obtaining claims information and building database for analysis.

Some important terms / definitions you have learnt in this chapter

a) Preamble
b) Express or Implied Conditions
c) Principles of Construction
d) Contra proferentum rule

Answers to Test Yourself

Answer to TY 1

The correct option is **B**

Contractual term for premium is consideration.

Answer to TY 2

The correct answer is **A**

The operative clause is also known as insuring clause.

Answer to TY 3

The correct option is **D**

Fraud is a condition subsequent

Answer to TY 4

The correct option is **B**

The written word takes precedent over the printed word

Answer to TY 5

The correct answer is **D**

Motor Cover note can be issued for 60 days.

Self-Examination Questions

Question 1

If the insurer wants to avoid liability on grounds of non-disclosure he must prove certain facts – which of the following is incorrect

A. Undisclosed facts were material
B. Facts were within the actual or presumed knowledge of the insured
C. Facts were not communicated to the insurer
D. The client was fraudulent

Question 2

Which of the following is not part of the fundamentals of a contract?

A. Offer and acceptance;
B. Legality (illegal contracts are void) and being capable of performance;
C. It must be in writing
D. Agreement (the consent of the parties is necessary for a contract to be enforceable);

Question 3

An endorsement follows a request for change/s in the policy. Which of the following will not be a subject for an endorsement?

A. Change of insured's address
B. Change in renewal date
C. Increase in sum insured
D. Cancellation of cover

Question 4

Section 64VB will advise the insured of that ____________

A. insurance will not be effective unless the premium is paid before cover is to commence

B. insurance will not be effective unless the insured reaffirms the declaration relating to material facts

C. insurance will not be effective if the cover is amended from that the renewal is based on

D. insurance will not be effective if there is any change in the agent or broker

Question 5

The conditions relating to the Motor certificate are covered in which act?

A. Motor Certificate Act, 1990

B. Motor Vehicles Act, 1988

C. Insurance Company Act, 1938

D. Motor Insurance Act, 1986

Answer to Self-Examination Questions

Answer to SEQ 1

The correct option is **D**

Insurer does not have to prove fraud to dispute a claim.

Answer to SEQ 2

The correct answer is **C**

The contract does not necessarily have to be in writing

Answer to SEQ 3

The correct answer is **A**

The change in insured's address is not a subject of an endorsement

Answer to SEQ 4

The correct answer is **A**

64VB relates to the payment of premium

Answer to SEQ 5

The correct answer is **B**

The Motor Vehicles Act 1988 covers the conditions relating to the motor certificate.

CHAPTER 3

GENERAL INSURANCE PRODUCTS – PART 1 (FIRE AND MARINE)

Chapter Introduction

The conventional classification of general insurance as provided under Section 2 of the Insurance Act, 1938 is as under:

(a) **Fire Insurance:** This branch covers the insurance of property against the risks of fire, riot, flood, earthquake, etc. and also includes insurance for loss of profits due to such damage.

(b) **Marine Insurance:**
   (i) **Cargo Insurance:** This branch deals with insurance of goods in transit by road, rail, sea or air against various risks,
   (ii) **Hull Insurance:** Hull insurance relates to the insurance of ocean-going steamers, motor launches, fishing vessels, etc., against such risks as fire, collision, storm, stranding, etc.

(c) **Miscellaneous Accident Insurance:** This branch consists of a wide variety of policies and deals with all types of insurances which are not transacted in fire or marine branches. Motor insurance, Engineering insurance, Burglary insurance, Fidelity Guarantee insurance, Personal Accident and Sickness insurance, Public Liability insurance and Workmen's Compensation insurance are some of the major classes of business in this branch.

However, over the years, the global market has changed significantly and to keep pace with the evolving business concepts, insurance terminology followed in India, also has changed. In recent times, general insurance is classified differently as under:

(a) **Insurances of property**: Fire insurance, marine insurance, burglary insurance, engineering insurance, motor vehicle insurance, aviation hull insurance, crop insurance and cattle insurance are important classes of insurance falling under this classification.

(b) **Insurances of persons**: In this classification will come the personal accident and sickness insurance.
(c) **Insurances of interest:** This classification comprises mainly the fidelity guarantee insurance.
(d) **Insurances of liability:** Public (third party) liability insurance, products liability insurance and professional indemnities fall under this classification.

The students may come across the term 'Reinsurance'. This is an arrangement whereby an insurer transfers a part of the risk to another insurer so that his share of a heavy loss is reduced. It may be called as insurance of insurance. Reinsurance is based on the same basic principle of insurance, i.e., to spread the losses of the 'few' over the 'many'. Contracts of 'reinsurance' are entered into between the insurers and the reinsurers. These are distinct from insurance contracts between the insurers and the insureds.

In the global scenario there are a number of ways the insurance markets classify insurance products, such as:

Retail and wholesale: where 'retail' connotes a direct product, usually aimed at the individuals, directly or through an agent e.g. home, personal, motor and individual health etc.; 'wholesale' connotes the brokered product – usually aimed at corporates.

Property and casualty (P&C): It is taken from the US markets, where property tends to be the first party covers, such as fire insurance, and casualty relates to the third party covers, such as liability insurance. However, the differentiations have become much greater with the newer forms of insurance, plus the stand-alone markets such as marine and aviation.

In this chapter, we will learn about the perils covered by the Standard Fire and Special Perils Policy and Consequential Loss (Fire) policy how it can be modified / customised to meet the specific needs of customers.

After going through this chapter, you would be able to understand how insurance takes care of the individuals' insurance needs.

Learning Outcomes

a) Understand the cover provided under Fire Insurance Policy
b) Understand the cover provided under Special Policies
c) Understand the cover provided under Consequential Loss (Fire) Policy
d) Understand the cover provided under Marine Cargo Policy
e) Understand the cover provided under Marine Hull Policy

1. Understand the cover provided under Fire Insurance Policy.

[Learning Outcome a]

Standard insurance policies are designed to provide a basic minimum cover at a reasonable premium, to make possible the purchase of this insurance by the majority of people. Fire Insurance is designed to provide financial protection for property against loss or damage by fire and other specified perils.

Examples of Insurable Property

- Buildings
- Contents of buildings such as machinery, plant & equipment, accessories, etc.
- Goods (raw materials, in process, semi-finished, finished, packing materials, etc.) in factories, warehouses and in the open.
- Contents in dwellings, shops, hotels, etc.
- Furniture, fixture and fittings, etc.

1.1 The Standard Fire and Special Perils Policy

The perils specified in the policy are Fire, Lightning, Explosion / Implosion, Aircraft damage, Riot, Strike and Malicious Damage. Other perils can be included in the coverage by endorsements with suitable additional premium and other terms. Details of these are given below:

Fire

Excluding destruction or damage caused to the property insured by

(a)(i) its own fermentation, natural heating or spontaneous combustion.
(ii) its undergoing any heating or drying process.
(b) burning of property insured by order of any Public Authority :
(**Note:** Spontaneous Combustion can be covered at extra premium)

Lightning

Explosion / Implosion

Explosion / Implosion cover excludes loss, destruction of or damage:
(a) to boilers (other than domestic boilers) or their contents resulting from their own explosion / implosion.
(b) caused by centrifugal forces.
(**Note:** This risk of steam generating boilers can be covered under Boiler Explosion Policy in Engineering Insurance).

Aircraft Damage

Destruction or damage caused by Aircraft, other aerial or space devices and articles dropped therefrom excluding those caused by pressure waves.

Riot, Strike and Malicious Damage

Loss of or visible physical damage or destruction by external violent means directly caused to the property insured by riot, strike, malicious damage.

Terrorism Damage

Terrorism damage is excluded in the standard policies. However it can be covered by payment of extra premium. The relevant wordings are as under:

Terrorism Damage Exclusion Warranty

"Notwithstanding any provision to the contrary within this insurance it is agreed that this insurance excludes loss, damage cost or expense directly or indirectly caused by, any act of terrorism.

For the purpose of this endorsement an act of terrorism means an act, including but not limited to the use of force or violence and / or the threat thereof, of any person or group(s) of persons whether acting alone or on behalf of or in connection with any organisation(s) or government(s), committed for political, religious, ideological or similar purpose including the intention to influence any government and / or to put the public, or any section of the public in fear."

Terrorism Cover

When the insured opts for Terrorism Damage cover by paying additional premium as provided, cover will be granted by attaching an endorsement.

Terrorism cover will be a separate cover which can be granted only in conjunction with Riot, Strike and Malicious Damage cover (RSMD), Terrorism cover will not be given in isolation without RSMD cover.

Deductibles for Terrorism cover

Every claim under terrorism cover will be subject to a deductible as under:

Industrial Risks: 0.5% of Total Sum Insured subject to a minimum of Rs. 1 lakh.
Non-industrial Risks: 0.5% of Total Sum Insured subject to a minimum of Rs. 25,000

Storm, Cyclone, Typhoon, Tempest, Hurricane, Tornado, Flood and Inundation (STFI)

The cover for natural perils is defined as: Loss, destruction or damage directly caused by Storm, Cyclone, Typhoon, Tempest, Hurricane, Tornado, Flood or Inundation excluding those resulting from earthquake, volcanic eruption or other convulsions of nature.

Earthquake

Wherever earthquake cover is given as an "add on cover" the words "excluding those resulting from earthquake, volcanic eruption or other convulsions of nature" are deleted from the above wording for storm etc.)

Impact Damage

"Loss or visible physical damage or destruction caused to the property insured due to impact by any Rail / Road vehicle or animal by direct contact not belonging to or owned by

a) the insured or any occupier of the premises or

b) their employees while acting in the course of their employment.

Subsidence and Landslide Including Rock Slide

"Loss, destruction or damage directly caused by subsidence of part of the site on which the property stands or Landslide / Rockslide excluding ……."

(a) the normal cracking, settlement or bedding down of new structures

(b) demolition, construction, structural alterations or repair of any property or underground works or excavations.

Bursting and / or Overflowing of Water Tanks, Apparatus And Pipes

Missile Testing Operations

Accidental Leakage from Automatic Sprinkler Installations

Bush Fire Excluding destruction or damage caused by Forest Fire.

1.2 Exclusions under Fire Insurance Policy

General Exclusions:

"This Policy does not cover

a) the first amount of 5% of each and every claim subject to a minimum of Rs.10,000/- in respect of each and every loss arising out of "Act of God" perils such as Lightning, STFI, Subsidence, Landslide and Rockslide.

b) the first Rs.10,000/- for each and every loss arising out of other perils.

(The deductible or excess in (a) & (b) is not applicable to dwellings)

c) Loss, destruction or damage caused by war, and kindred perils.

d) Loss, destruction or damage directly or indirectly caused to the property insured by nuclear peril.

e) Loss destruction or damage caused to the insured property by pollution or contamination excluding
   i) pollution or contamination which itself results from a peril hereby insured against.
   ii) any peril hereby insured against which itself results from pollution or contamination.

f) Loss, destruction or damage to bullion or unset precious stones, curios or works of art for an amount exceeding Rs.10,000/-, manuscripts, plans, drawings, stamps, coins or paper money, cheques, books of accounts or other business books, computer systems records, explosives etc. unless otherwise expressly stated in the policy.

g) Loss, destruction or damage to the stocks in Cold Storage premises caused by change of temperature.

h) Loss, destruction, or damage to any electrical machine, apparatus, fixture or fitting arising from or occasioned by over-running, excessive pressure, short circuiting, arcing, self-heating or leakage of electricity from whatever cause (lightning included) provided that this exclusion shall apply only to the particular electrical machine, apparatus, fixture or fitting so affected and not to other machines, apparatus, fixture of fittings which may be destroyed or damaged by fire so set up.

   This is known as “Electrical Risks” exclusion. These risks can be covered under Machinery Insurance policy (Engineering Insurance).

   It is to be noted that only damage to the particular electric machine, etc by specified electrical risks is excluded; but resulting fire damage to other machines etc. is covered.

i) Expenses incurred on (a) Architects, Surveyors and Consulting Engineer's Fees and (b) Debris Removal necessarily incurred by the Insured following a loss destruction or damage to the property insured by an insured peril in excess of 3% and 1% of the claim amount respectively.
(**Note:** Cover for expenses in excess of 3% and 1% can be arranged by endorsement)

The other exclusions under the policy are:

a) Loss or damage by spoilage from the interruption of any process caused by any of the perils covered.
b) Loss or damage by earthquake.
c) Loss or damage to insured property if removed to any building or place other than the insured premises (except machinery temporarily removed for repairs, etc, for a period not exceeding 60 days)
d) Theft during or after the occurrence of any insured peril.

(**Note:** Add-on cover at additional premium is available for (a), (b) & (c))

1.3 General Conditions of Fire Insurance Policy

There are 15 conditions in the policy. Provisions of these conditions are briefly explained.

i. This policy shall be voidable in the event of mis-representation, mis-description or non-disclosure of any material particular. This condition deals with the principle of utmost good faith.

ii. All insurance under this policy shall cease on expiry of seven days from the date of fall or displacement of any building or part thereof. Provided such a fall or displacement is not caused by insured perils. However, the company, subject to an express notice being given as soon as possible but not later than 7 days of any such fall or displacement, may agree to continue the insurance subject to revised rates, terms & conditions as may be decided by it and confirmed in writing to this effect.

iii. Under any of the following circumstances the insurances ceases to attach as regards the property affected unless the insured, before the occurrence of any loss or damage, obtains the sanction of the company signified by endorsement.

(a) If the trade or manufacture carried on be altered, or if the nature of the occupation of or other circumstances affecting the building insured or containing the insured property be changed in such a way as to increase the risk of loss or damage by the Insured Perils.

(b) If the building insured or containing the insured property becomes unoccupied and so remains for a period of more than 30 days.

(c) If the interest in the property insured passes from the insured otherwise than by will or operation of law.

These are material changes in the risk and hence must be notified to the company. However, on the death of the insured the legal heirs automatically become the insured.

iv. If there is a marine policy covering the loss; the fire policy will pay only the excess over the amount payable under the marine policy.

v. This condition deals with the cancellation of the policy by either of the parties to the contract. If the cancellation is by the insured then the premium is retained by the company on short period basis. The insurance company can also cancel the policy by giving 15 days notice to the insured and in such a case the premium will be refunded on pro-rata basis.

vi. This condition deals with duties of the insured on happening of a loss which are :

(a) Notice of loss / damage should be given to the Insurer forthwith.
(b) Within 15 days or further time as allowed by the insurance company submit a claim statement giving itemwise details of amount of loss not including profit of any kind.
(c) Particulars of other insurances should also be submitted.

Non-compliance of this condition will make the claim untenable.

The second part of this condition makes two provisions.

a) The insurer is not liable for any loss after the expiry of 12 months from the date of loss unless the claim is the subject of pending action or arbitration.
b) If liability is disclaimed by the insurer and the insured has not filed a suit in a court of law, within 12 months of the date of disclaimer, the claim is deemed to have been abandoned by the insured. It is not recoverable thereafter.

vii. This condition provides for certain rights of the insurers following the occurrence of a loss. Insurers can

(a) enter and take possession of the building or premises where the loss has occurred.

(b) remove, sort, arrange or salvage the property

If the insured or any person on his behalf does not co-operate or hinders the process in any way then all benefits under this policy shall be forfeited.

The insured does not have any right to abandon damaged property whether the insurer takes possession or not.

viii. If the claim is fraudulent then the insured loses all benefits under the policy.

ix. This condition gives the insurer the option to reinstate or replace the property that is lost / damaged instead of paying the amount of claim to the insured.

x. This is the condition of average. An insured is expected to insure his property for its full value. In the event of claim if it is found that he has not covered the property for its full value, then he has to bear a portion of the claim for his own account.

Example:

Value of Property	Rs. 2,00,000
Sum Insured	Rs. 1,50,000
Loss	Rs. 80,000

The amount payable

$$= \frac{1,50,000}{2,00,000} \times 80,000 = \text{Rs. } 60,000$$

xi. This condition provides that in the event of more than one policy covering the loss; all policies will contribute towards the claim amount in the proportion that the particular policy's sum insured bears to the total sum insured under all the policies (contribution).

xii. If the loss is caused by a third party the insured is required to give assistance to the insurers to enable them to recover the loss from the third party responsible for the loss. The insured's rights of recovery against the third party are subrogated to the insurers, and this transfer of rights takes place even before the insurers pay the loss. (This is the subrogation condition).

xiii. Any dispute regarding the amount of claim payable (liability having been admitted by the insurers) shall be referred to arbitration as per the provisions of the Arbitration and Conciliation Act, 1996.

Arbitration is a private method of dispute resolution out of the court of law and is faster and cheaper than the process of litigation.

xiv. Every notice and other communication to the company required by these conditions must be written or printed.

xv. Upon the settlement of any loss under this policy, prorata premium for the unexpired period from the date of such loss to the expiry period of insurance for the amount of such loss shall be payable by the Insured to the company.

The additional premium referred to above shall be deducted from the net claim payable under the policy. However, the sum insured shall stand reduced by the amount of loss in case the insured immediately on occurrence of the loss exercises his option not to reinstate the sum insured as above.

1.4 Add-on Covers

The following 'Add-On' covers are available at extra premium.

a) Architects, etc. Fees (in excess of 3% of claim amount)

Covers under the standard policy apply only upto 3% of the claim amount. The extension provides cover for a higher limit i.e. upto 7.5% of the adjusted loss.
(The sum insured on buildings, machinery should be increased to include such fees)

b) Debris Removal Expenses (in excess of 1% of claim amount)

Following a loss, the insured may have to incur costs and expenses

i) in the removal of debris from the insured premises.
ii) dismantling or demolishing.
iii) shoring or propping up of the portion of the property, insured destroyed or damaged by insured perils.

The sum insured for the extension is separately fixed not exceeding 10% of the total sum insured.

c) Deterioration of Stocks in Cold Storage premises

There are two types of extension of cover for deterioration of stocks caused by change of temperature.

(A) Destruction of or damage to the insured property by change of temperature in consequence of failure of electric supply at the terminal ends of electric service feeders from which the insured obtains electric supply directly due to damage by an insured peril to property at any Electric Station or Sub-Station of Public Supply undertaking from which the insured obtains electric supply.

(B) Destruction of or damage to insured property by change of temperature in consequence of failure of electric supply following damage to property at the insured's premises.

The extension does not cover any loss due to any act of government, municipal authority etc or due to rationing etc of power supply.

d) Spontaneous Combustion

This extension covers loss or damage **by fire only** of the insured property caused by its own fermentation, natural heating or spontaneous combustion.

Spontaneous combustion means burning which results from internal heating and not from external causes. This takes place in certain commodities e.g. groundnuts, dyes, chemicals, paints and varnish, gunnies, hay and grass, copra cake, etc.

e) **Forest Fire**

The extension covers loss or damage to the property insured directly caused by burning, whether accidental or otherwise, of forests and jungles and the clearing of lands by fire.

f) **Impact** Damage

Impact damage due to Insured's Own Rail / Road Vehicles, Forklifts, cranes, stackers and the like and articles dropped therefrom.

g) Earthquake (Fire and Shock)

Earthquake (Fire and Shock) add-on cover is available in two types:

i) If option to delete STFI perils under Standard policy is not exercised.

The extention covers loss or damage (including loss or damage by fire) to property insured by earthquake **including** flood or overflow of the sea, lakes, reservoirs and rivers and / or Landslide / Rockslide resulting therefrom.

ii) If option to delete STFI perils under standard policy is exercised the cover applies for loss or damage (including fire) by earthquake including Landslide / Rockslide resulting therefrom but **excluding** flood or overflow of the sea, lakes, reservoirs and rivers caused by earthquake.

The extension is subject to the following:

Excess is 5% of each and every claim subject to a minimum of Rs.10,000/-.

Coverage applies to both fire damage and shock damage.

h) Spoilage Material Damage cover under a separate item in the policy relates to

(i) loss of stock in process; and

(ii) damage to machinery, containers and equipment (including cost of removal of debris and cleaning).

The policy is extended to cover "loss or damage by spoilage resulting from the interruption or cessation of any process or operation caused by any of the perils covered by the policy." Subject to the proviso that liability for damage to the property insured is first admitted by the company.

All stocks must be covered with a separate sum insured for each block subject to pro-rata average, if under-insured.

i) Temporary Removal

The extension provides cover in respect of insured stocks (not exceeding 10% of the total sum insured of such stock) while temporarily removed to any other premises for fabrication.

j) **Loss of Rent** is covered if the insured building or any part thereof is unfit for occupation as a result of damage by insured perils.

- the owner-occupant to insure both buildings and contents.
- the tenant to insure the contents of the premises for which this extension is sought.

j) **"Start-up Expenses":** The policy is extended to "cover Start-up costs necessarily and reasonably incurred by the insured consequent upon a loss or damage covered by this policy".

l) **Escalation Clause:** This clause, applicable to policies on Buildings, Machinery and Accessories only, can be incorporated in policies on payment of additional premium.

The clause allows automatic regular increase, not exceeding 25%, in the sum insured throughout the period of the policy. The automatic increase operates from the date of inception upto the date of occurrence of any of the insured perils. Pro-rata condition of average will apply as usual.

2. Understand the cover provided under Special Policies. [Learning Outcome b]

Floater Policy

These policies cover stocks at various specific locations under one sum insured. The insured may have stocks in two or more godowns. He is able to declare for insurance the total value of goods in all godowns but not separate values for each godown.

Unspecified locations are not allowed. Similarly, in a manufacturing risk, the stocks in the process blocks, godowns and / or in the open can be covered under one sum insured.

Declaration Policies

To take care of frequent fluctuations in stocks / stock values, Declaration Policy(ies) can be granted subject to the following conditions:

a. The policy is issued for a sum insured selected by the insured. (Insurers stipulate a minimum sum insured).
b. Monthly declarations based on the average of the value at risk on each day or highest value on any day of the month shall be submitted by the Insured. If declarations are not received within the specified period, the full sum insured under the policy shall be deemed to have been declared.
c. Refund of premium on adjustment based on the declaration / cancellations shall not exceed 50% of the total premium.

Illustration

Sum insured	:	Rs.1,00,00,000 (1 crore)
Rate	:	Rs.1.00 per mille (Re. 1 for every Rs. 1000 sum insured)
Premium	:	Rs.10,000/-

Monthly Declarations

January	52,00,000
February	56,00,000
March	46,00,000
April	46,00,000
May	30,00,000
June	30,00,000
July	30,00,000
August	30,00,000
September	40,00,000
October	40,00,000
November	40,00,000
December	40,00,000
Total Declarations	**4,80,00,000**
Average Sum Insured	**40,00,000**
Premium	10,000
Premium on average sum insured	4,000
	6,000

According to rules, refund cannot exceed 50% of the total premium. Therefore, refund is Rs.5,000/- and not Rs.6,000/-.

Reinstatement Value Policy

This is the fire policy with the reinstatement value clause attached to it. The clause provides that in the event of loss, the amount payable is the cost of reinstating property of the same kind or type, by new property.

This basis of settlement differs from the basis under the standard fire policy where the losses are settled on the basis of market value i.e. making deductions for depreciation, etc.

The reinstatement value clause incorporates the following special provisions:

a) Reinstatement must be carried out by the insured and completed within 12 months after the destruction or damage, failing which the loss will be settled on the normal indemnity basis i.e. according to the Fire Policy.

b) The reinstatement basis of settlement will not apply

   (i) If the insured fails to intimate to the insurer within 6 months or any extended time his intention to replace the damaged property.

(ii) If the insured is unable or unwilling to replace the damaged property. In such cases the loss will be settled on the normal basis of indemnity.

c) The work of reinstatement may be carried out upon another site and in any manner required by the insured provided the liability under the policy is not thereby increased.

These insurances are granted to insureds whose bonafides are satisfactory and, are generally issued only in respect of building, plant and machinery in a comparatively new condition.

These insurances are not granted on stocks.

Industrial All Risks Insurance Policy

This is a package cover designed for industrial risks (both manufacturing and storage facilities) with an overall sum assured of Rs.100 crores and above. The policy provides cover for the following:

- Fire and special perils
- Burglary
- Machinery Breakdown / Boiler Explosion / Electronic Equipment (Material damage)
- Business Interruption (Fire & allied perils)
- Business Interruption (Machinery Breakdown). This is an optional cover.

Under insurance of upto 15% is permitted. Apart from the reduced costs of premium, there is administrative convenience both for the insured and the insurer as they have to deal with less documentation as compared to separate policies for each cover.

Agreed Bank Clause

All policies in which a Bank has a partial interest are to be made out in the name of the Bank and Owner or Mortgagor and the Agreed Bank Clause incorporated in the policy.

The salient features of the clause are:

a) The claim is payable to the bank whose receipt shall be a complete discharge and binding on all parties insured.

b) Any settlement, compromise etc. in relation to dispute if made with the bank shall be valid and binding on all parties insured.

Fire Proposal Form

The fire proposal form elicits details of the insured, address of corporate office and works, nature of business, system of working (i.e. whether single or multiple shifts), Description of the property etc. It will also include the following information:

(i) Construction of external walls and roof, number of storeys.
(ii) Occupation of each portion of the building.
(iii) Presence of hazardous goods.
(iv) Process of manufacture.
(v) The sums proposed for insurance.
(vi) The period of insurance.
(vii) History of previous losses.
(viii) Insurance history – whether previously other insurers had declined the risk, etc.

3. Understand the cover provided under Consequential Loss (Fire) Policy.

[Learning Outcome c]

Fire insurance is designed to provide protection in respect of loss of or damage to buildings, machinery, furniture and fittings, goods and merchandise, etc. by fire and allied perils. The insurance affords cover for "material damage". However an indemnity for the "material damage" does not provide complete protection to the insured who may also suffer trading losses due to total or partial stoppage of the business.

The purpose of consequential loss (also known as Loss of Profits i.e. LOP or Business Interruption Insurance) is, therefore, to make good these losses, namely net profit, standing charges and increased cost of working.

Turnover of a business consists of the following elements:

a) **Variable Charges:** These are expenses incurred in producing the goods (e.g. purchase of raw materials, wages, etc.)
b) **Standing Charges:** These expenses are fixed in amount irrespective of the volume of the business transacted (e.g. taxes, bank interest, salaries to permanent staff, etc.)
c) **Net Profit:** This is turnover minus variable and standing charges.
d) **Gross Profit:** Standing charges and net profit together constitute the gross profit of the business.

Indemnity Period

The profits policy provides indemnity in respect of loss of gross profits during the indemnity period which is selected by the insured. The indemnity period chosen by the insured may vary from 3 months to 3 years.

The indemnity period is to be distinguished from the period of insurance which is usually a year; the insured peril must occur during the period of insurance and the indemnity period which commences on the date of loss and terminates when the business returns to normal level.

The Sum Insured

The sum insured is to be fixed by the insured. As the indemnity provided by the consequential loss policy is in respect of loss of gross profits for the indemnity period naturally the sum insured should represent the gross profits of the indemnity period selected. Where the indemnity period is 12 months or less, the sum insured should be the annual amount of the gross profit i.e. the annual amount of the net profit and the insured standing charges. Where the indemnity period is 24 months, the sum insured should represent twice the annual gross profit and so on.

The sum insured is to be computed from the Insured's accounts. The standing charges have to be specified by the insured. Some examples of the standing charges are:

- Interest on loans, bank overdrafts and debentures, including brokerage on deposits;
- Rent
- Directors fees and remuneration;
- Legal, auditing and other professional fees and expenses;
- Insurance Premiums;
- Advertising and Publicity expenses;
- Conveyance, Stationery, Postage, Telephone, Telex, Telegram expenses;
- Office and General Establishment expenses;
- Salaries to permanent staff including Employees State Insurance Contributions;
- Wages (including Employees State Insurance Contributions), etc.

The loss becomes Payable when:
a) Fire or other insured peril must occur at the insured premises.
b) Property used for the business of the insured at the insured premises must be destroyed or damaged.
c) The business must be interrupted or interfered with, as a consequence.
The resulting loss is paid in accordance with the provisions of the policy.

(**Note:** A formula is incorporated in the policy to calculate the loss. This is known as "Specification")
Payment of loss under the L.O.P. policy is subject to payment or admission of liability of the loss under the material damage insurance i.e. Fire and special perils policy. (This is the 'material damage' provisio).

Test Yourself 1

Question 1

Replacement cost is paid for the property by the insurer under which policy?

A. Declaration Policy
B. Reinstatement Value Policy
C. Floating Policy
D. Consequential Loss Policy

4. Understand the cover provided under Marine Cargo Policy.

[Learning Outcome d]

4.1 Different types of marine insurance policies

Marine insurance, the oldest branch of insurance, comprises:
(a) Cargo insurance and
(b) Hull insurance.

- Marine Hull Insurance – covers loss or damage to the actual structure of the vessel and its machinery
- Marine Cargo Insurance – covers loss or damage to the cargo on the carrying vehicle, vessel, etc. and during incidental storage

Definition

The Insurance Act, 1938, Section 2 (13A) defines Marine Insurance business as "the business of effecting contracts of insurance upon vessels of any description, including cargoes, freights and other interests which may be legally insured, in or in relation to such vessels, cargoes and freights, goods, wares, merchandise and property of whatever description insured for any transit by land or water, or both, and whether or not including warehouse risks or similar risks in addition or as incidental to such transit, and includes any other risks customarily included among the risks insured against in marine insurance policies".

Marine Insurance Act, 1963

This Act provides the legal framework for transaction of marine insurance – both cargo and hull. The act deals with basic principles, basis of valuation under the policies, basis of settlement of losses etc.

Marine Insurance Practice:

Various documents used in cargo insurance are:

- **Cover Note**

A cover note is a document granted provisionally pending issue of a regular policy. It happens frequently that all details required for the purpose of issuing a policy are not available. For instance, the name of the steamer, the number and date of railway receipt, the number of packages involved in transit, etc., may not be known.

- **The Marine Policy Form**

A contract of marine insurance is evidenced by the policy and the clauses attached to it. The policy form contains only details such as name of the insured, details of shipment or consignment, sum insured, etc. It is the clauses which specify the risk covered, risks excluded and other terms and conditions of insurance.

The policy form contains following particulars:

- Name of insured,
- Policy number,
- Sum insured,
- Premium,
- Stamp duty,

- Steamer or other conveyance,
- Voyage or journey,
- Number and date of bill of lading,
- Rail or lorry or registered post or air freight receipt (as the case may be),
- Interest to be insured,
- Clauses to which the insurance is subject,
- Name and address of settling agents to whom notice of claim, if any, is to be given,
- Place where claims are payable,
- Place of issue of policy and date,
- Signature of the authorised person signing on behalf of the insurers.

Every marine policy must be stamped in accordance with the provisions of the Indian Stamp Act.

- **The Clauses:**

For export / import policies, the Institute Cargo Clauses (I.C.C.) are used. These clauses are drafted by the Institute of London Underwriters (ILU) and are used by insurance companies in a majority of countries including India. For Inland Transit risk, Indian insurers use the clause drafted earlier by Tariff Advisory Committee.

- **Slip**

Apart from the clauses, a slip printed in red and marked "Important" (known as 'red slip') is also attached. The slip draws the attention of consignees to certain procedures to be followed by them to preserve rights of recovery against carriers etc.

4.2 Marine Cargo Insurance

Marine Cargo insurance plays an important role in domestic as well as in international trade. Most contracts of sale require that the goods must be insured, either by the seller or the buyer, against loss or damage.

Marine Cargo insurance concerns the following:

- export and import shipments by ocean-going vessels of all types,
- coastal shipments by steamers, sailing vessels, mechanised boats, etc.,
- shipments by inland vessels or country craft, and
- consignments by rail, road, or air and articles sent by post

Who effects the Insurance

A contract of sale involves mainly a seller and a buyer, apart from other associated parties like carriers, banks, clearing agents, etc. The question as to who is responsible for effecting insurance on the goods, which are the subject for sale, depends on the terms of the sale contract. The principal types of sale contracts, in so far as marine insurance is directly concerned, are as follows:

Type of contract	**Responsibility for Insurance**
Free on Board (**F.O.B**.)	The seller is responsible till the goods are placed on board the steamer. The buyer is responsible thereafter. He can get the insurance done wherever he likes.
Free on Rail (**F.O.R.**)	The provisions are the same as in (a) above. This is mainly relevant to internal transactions.
Cost & Freight (**C&F**)	Here also, the buyer's responsibility normally attaches once the goods are placed on board. He has to take care of the insurance from that point onwards.
Cost, Insurance & Freight (**C.I.F**.)	In this case, the seller is responsible for arranging the insurance. He includes the premium charge as part of the cost of goods in the invoice.

The normal practice in export / import trade is that the exporter asks the importer to open a letter of credit with a bank, in his favour. As and when the exporter is ready for shipment of the goods, he hands over the documents of title to the bank and gets the bill of exchange drawn by him on the importer, discounted with the bank. In this process, the goods which are the subject of the sale are considered by the bank as physical security against the monies advanced by it to the exporter. A further security by way of an insurance policy is also required by the bank to protect its interests in the event of the goods suffering loss or damage in transit, in which case the importer may not make the payment. The terms and conditions of insurance are specified in the letter of credit.

Institute Cargo Clauses:

Three types of covers are available for export / import shipments by sea, under different Clauses, as under:

Institute Cargo Clauses (C)

This covers the following risks / contingencies:

- fire or explosion
- vessel or craft being stranded, grounded, sunk or capsized
- overturning or derailment of land conveyance
- collision or contact of vessel, craft or conveyance with any external object other than water
- discharge of cargo at a port of distress
- general average sacrifice
- jettison

Institute Cargo Clauses (B)

In addition to the cover under I.C.C. (C), this covers following additional risks:

- Earthquake, Volcanic eruption or lightning
- Washing overboard
- Entry of sea, lake or river water into vessel, craft, hold, conveyance, container, liftvan or place of storage
- Total loss of any package lost overboard or dropped whilst loading on to, or unloading from vessel or craft.

Apart from the risks covered under these clauses, cargo is also subject to many other risks which are known as 'extraneous risks'. These risks, which can be added to I.C.C. (B) on payment of extra premium are:

- Theft, pilferage and / or non-delivery.
- Fresh water and rainwater damage.
- Hook and / or oil damage.
- Heating and sweating.
- Damage by mud, acid and other extraneous substances.
- Breakage.
- Leakage.
- Country damage.
- Bursting / tearing of bags.

Institute Cargo Clauses (A)

These clauses provide cover for all risks of loss or damage, to the subject matter insured. The term 'all risks' means losses which are caused by accidental circumstances only. Under I.C.C. (C) and (B), the risks covered are specified; Under 'A' clauses the risks covered are not specified and 'all risks' are covered.

Exclusions

All three sets of clauses contain general exclusions. The more important exclusions are:

a. Loss caused by wilful misconduct of the insured.
b. Ordinary leakage, ordinary loss in weight or volume or ordinary wear and tear.
c. These are normal 'trade' losses which are inevitable and not accidental in nature.
d. Loss caused by inherent vice or nature of the subject matter. For example, perishable commodities like fruits, vegetables, etc. may deteriorate without any accidental cause. (This is known as 'inherent vice')
e. Loss caused by delay, even though the delay be caused by an insured risk.
f. Deliberate damage by the wrongful act of any person. This is called 'malicious damage' and can be covered, at extra premium, under (B) and (C) clauses. Under 'A' clauses, the risk is automatically covered.
g. Loss arising from insolvency or financial default of owners, operators, etc. of the vessel. Many shipowners, especially tramp vessel owners, fail to perform the voyage due to financial troubles with consequent loss or damage to cargo. This is not an accidental loss. The insured has to be cautious in selecting the vessel for shipment.
h. Loss or damage due to inadequate packing
i. War and kindred perils.
j. Strikes, riots, lock-out, civil commotions and terrorism.

(Note: The risks under (h) & (i) can be covered on payment of extra premium. The Institute War and Strikes clauses are attached to the policy).

Duration of Cover

As against "time policies" issued in other classes of insurance which cover the subject matter for a specified period, usually one year, cargo policies are issued for specified voyage or transit whatever the time taken. It is necessary to be clear as to when exactly risk commences and terminates under a voyage policy.

The duration of cover is defined in the Transit Clause (popularly known as Warehouse to Warehouse Clause) of the ICC.

The cover commences from the time the goods leave the warehouse at the place named in the policy, continues during the ordinary course of transit and terminates either

- On delivery to the consignees' or other final warehouse at the destination named
- On delivery to any intermediate warehouse used by the insured for purposes of storage or distribution or
- On the expiry of 60 days after discharge from the vessel at the final port of discharge **whichever shall first occur.**

(Note: The time limit of 60 days is prescribed to ensure early clearance of goods by the consignee. Insurers extend the time limit, at extra premium, in genuine circumstances causing delay in clearance.)
The duration of cover for war risks is restricted to the time when the goods are water borne and not on land. War risk on land is not covered under insurance policies.

Institute Cargo Clauses (Air) (Excluding Sendings by Post)
The risks covered are all risks of loss or damages and the exclusions are more or less the same as under ICC (A) Clauses.

The duration of cover is the same as under ICC (A) except that the period of cover after unloading of cargo from the aircraft at the final place of discharge is limited to 30 days (as against 60 days for shipments by sea under ICC (A). War and SRCC risks can be covered at extra premium.

4.3 Inland Transit (Rail / Road) Clauses

a) Inland Transit (Rail / Road) Clause 'C'

Risks Covered – Fire risks only
Risks of physical loss/damage to the subject matter, caused by:

a) Fire
b) Lightning

Duration of Cover

Insurance attaches with the loading of each bale/package into the wagon / truck for commencement of transit and continues during ordinary course of transit, including customary transhipments and ceases immediately on unloading of each bale/package –

- at destination railway station for rail transits
- at destination named in the policy in respect of road transits.

b) Inland Transit (Rail / Road) Clause 'B'

Risks Covered - Physical loss or damage to the insured goods by

- Fire
- Lightning
- Breakage of bridges
- Collision with or by the carrying vehicle
- Overturning of the carrying vehicle
- Derailment or accidents of like nature to the carrying railway wagon / vehicle.

Extraneous risks like theft, pilferage, non-delivery etc. can be added to the cover at extra premium. SRCC risks can also be added.

c) Inland Transit (Rail / Road) Clause 'A'

Risks Covered - All risks of loss or damage to the insured goods.

• Exclusions

All three sets of clauses have the same exclusions as are found in ICC Clauses.

• Duration of Cover

Under these clauses the risk attaches from the time the goods leave the warehouse and / or the store at the place named in the policy for the commencement of transit and continues, during the ordinary course of transit, including customary transhipment, if any,

(i) until delivery to the final warehouse at the destination named in the policy, or

(ii) in respect of transits by Rail only or Rail and Road, until expiry of 7 days after arrival of the railway wagon at the final destination railway station, or

(iii) in respect of transits by Road only, until expiry of 7 days after arrival of the vehicle at the destination town named in the policy, whichever shall first occur.

• Registered Postal Sendings

There is no standard set of clauses. ICC or Inland Transit Clauses may be used. The cover attaches from the time of issue of the registered post receipt and terminates on delivery of parcel to the addressee (consignee). For interests which are valuable, it is warranted that the parcel is insured with the postal authorities.

4.4 Types of marine policies

- **Specific Policy**

A policy covering a single shipment or consignment is known as specific policy. It is valid for a particular voyage or transit.

- **Open Policy**

An open policy is also known as ‘floating policy’. It is worded in general terms and is issued to take care of all shipments coming within its scope. It is issued for a substantial amount to cover shipments or sendings during a particular period of time. Declarations are made under the open policy and these go to reduce the sum insured.

Open policies are normally issued for a year. If they are fully declared before that time, a fresh policy may be issued, or an endorsement placed on the original policy for the additional amount. On the other hand, if the policy has run its normal period and is cancelled, a proportionate premium on the undeclared balance is refunded to the insured if the full premium had been collected earlier.

On receipt of each declaration, a separate certificate of insurance is issued. An open policy is a stamped document, and, therefore, certificates of insurance issued thereunder need not be stamped.

Open policies are also issued to cover inland consignments.

There are certain advantages of an open policy compared to specific policies. These are:

- Automatic and continuous insurance protection.
- Administrative work is considerably reduced.
- Some saving in stamp duty. This may be substantial, particularly in the case of inland sendings.

- **Open Cover**

An open cover is particularly useful for large export and import firms making numerous regular shipments who would find it inconvenient to obtain insurance cover separately for each and every shipment. It is also possible that through an oversight on the part of the insured a particular shipment may remain uncovered and should a loss arise in respect of such shipment, it would fall on the insured themselves. In order to overcome such a disadvantage, a permanent form of insurance protection by means of an open cover is taken by big firms having regular shipments.

There is no limit to the total number or value of shipments that can be declared under the open cover.

An open cover describes the cargo, voyage and cover in general terms and takes care automatically of all shipments which fall within its scope. It is usually issued for a period of 12 months and is renewable annually. It is subject to cancellation by either insurers or the insured, by giving due notice.

The following are important features of an open policy / open cover:

(a) **Limit per bottom or per conveyance:**
The limit per bottom means that the value of a single shipment declared under the open cover should not exceed the stipulated amount.

(b) **Basis of Valuation:**
The basis normally adopted is the prime cost of goods, freight and other charges incidental to shipment, cost of insurance, plus 10% to cover profits,.

(c) **Location Clause:**
The location clause limits the liability of insurers at any one time or place before shipment. Generally, this is the same limit as the limit per bottom or conveyance specified in the cover, but sometimes it may be agreed at an amount, say, upto 200% thereof.

(d) **Rate:**
A schedule of agreed rates is attached to each open cover.

(e) **Terms:**
There may be different terms applying to different commodities covered under the open cover, and they are clearly stipulated.

(f) **Declaration Clause:**
The insured is made responsible to declare each and every shipment coming within the scope of the open cover. An unscrupulous insured may omit a few declarations, to save premium, specially when he knows that shipment has arrived safely.

(g) **Cancellation Clause:**
This clause provides for cancellation of the contract with a certain period of notice. In case of War & S.R.C.C. risks, the period of notice is much shorter.

Since no stamps are affixed to the open cover, specific policies or certificates of insurance are issued against declaration & are required to be stamped according to the Stamp Act

- **Difference between open policy & open cover:**

a) The open policy is a stamped document and is, therefore, legally enforceable in itself, whereas an open cover is unstamped and has no legal validity unless backed by a stamped policy.

b) An open policy is issued for a fixed sum insured, whereas there is no such limit of amount under an open cover. As and when shipments are made under the open policy, they have to be declared to the insurers and the sum insured under the open policy reduces by the amount of such declarations. When the total of the declarations amounts to the sum insured under the open policy, the open policy stands exhausted and has to be replaced by a fresh one.

- **Certificate of Insurance**

A certificate of insurance is issued to satisfy the requirements of the insured or the banks in respect of each declaration made under an open cover and / or open policy. The certificate, which is substituted for specific policy, is a simple document containing particulars of the shipment or sending. The number of open contract under which it is issued, is mentioned, and occasionally, terms and conditions of the original cover are also mentioned. Certificates need not be stamped when the original policy has been duly stamped.

- **Special Declaration Policy**

This is a form of floating policy issued to clients whose annual estimated dispatches (i.e. turnover) by rail / road / inland waterways exceeds Rs.2 crores. Declarations of dispatches are made at periodical intervals and premium is adjusted on expiry of the policy based on total declared amount.
When the policy is issued sum insured is based on previous year’s turnover or in case of fresh proposals, on a fair estimate of annual dispatches. A proposal form is used.

- **Special Storage Risks Insurance**

This insurance is granted in conjunction with an open policy or a special declaration policy. The purpose of this policy is to cover goods lying at the Railway premises or carrier’s godowns after termination of cover under open or special declaration policies but pending clearance by the consignees. The cover terminates when delivery is taken by the consignee or payment is received by the consignor, whichever is earlier.

- **Annual Policy**

This policy, issued for 12 months, covers goods belonging to the insured, which are not under contract of sale, and which are in transit by rail or road from specified depots / processing units to other specified depots / processing units. Cover is provided in terms of Inland Transit (Rail / Road) Clauses as desired.

- **"Duty" Insurance**

Cargo imported into India is subject to payment of Customs Duty, which can be included in insured value under a Marine Cargo Policy, or a separate policy can be issued in which case the Duty Insurance Clause is incorporated. It is warranted that the claim under Duty Policy would be payable only if the claim under cargo policy is payable. The insured has therefore to produce proof of the Cargo claim having been settled or liability admitted by the cargo Insurers. But this provision is not applied where CIF insurance is arranged by the exporter as required by the contract of sale. This insurance shall not be valid if effected after the arrival of the vessel at the destination port.

- **"Increased Value" Insurance**

Insurance may be arranged to cover increased value of the cargo, if the Market Value of the goods at destination port on the date of landing is higher than the CIF and Duty value of the cargo.

(Note: Duty & Increased Value policies are issued only on imports)

4.5 Claims

The marine perils discussed earlier give rise to different types of losses. The liability under the policy depends firstly, on the loss being caused by an insured peril, and secondly, on being proximately caused by such insured peril.

- **Total Loss**

Goods may be totally lost by the operation of the marine peril. The measure of indemnity in the event of total loss of the goods is the full insured value. The insurers are entitled to take over the salvage, if any.

An actual total loss takes place where the subject matter is entirely destroyed or damaged to such an extent that it is no longer a thing of the kind insured.

As against actual total loss, a constructive total loss, which is a commercial total loss, takes place where the subject matter insured is abandoned on account of the actual total loss being inevitable, or where the expenditure to be incurred for repairs or recovery would exceed the value of the subject-matter after the repairs or recovery.

- **Particular Average**

These are partial losses. They occur when there is a total loss of part of the goods covered, e.g., a consignment may consist of 100 packages of which 5 packages may be lost completely. Another way in which particular average loss occurs is when there is damage to the goods. Where whole or any part of the goods insured is delivered damaged at destination, the percentage of depreciation is ascertained by a surveyor appointed for the purpose, by comparing on the one hand the gross sound market value and, on the other, the gross damaged market value on arrival of the goods at destination. The depreciation is expressed as a percentage of the insured value under the policy.

- **General Average**

General Average is a loss caused by a general average act. An act is referred to as general average act when an extraordinary sacrifice or expenditure is made. Such an act should be voluntary, and the expenditure reasonable. It should be undertaken with the sole idea of preserving the property imperilled in an adventure. It is shared proportionately by all the interests at risk at the time of the general average act, i.e. ship, cargo and freight The following are examples of a general average loss:

- Cargo jettisoned in an effort to refloat the vessel.
- Tugs employed to tow the vessel to safety.

The adjustment of general average is done by specialists known as G.A. adjusters.

- **Salvage Loss**

When the goods insured are damaged during transit, and the nature of the goods is such that they would deteriorate further and would be worthless by the time the vessel arrives at destination, it would be a prudent and sensible to dispose off the same at an intermediate port for the best price obtained. The term ‘salvage loss’ refers to the amount payable which is the difference between the insured value and the net proceeds of the sale.

- **Sue and Labour Charges**

Insurers expect that the insured should at all times act as if he was uninsured and take such steps as a prudent person would normally take. In view of this, if there be any expenses incurred by the insured or his agents to minimse the loss or damage payable under the policy, the same are reimbursed by insurers. Examples of such charges, known as Sue and Labour charges, are landing, warehousing, reconditioning, reforwarding and similar charges.

- **Extra Charges**

Under this expression come survey fees, settling agents fees, etc. They are payable if the claim is admitted. Whenever a survey is arranged, the fees are paid by the claimant initially and are reimbursed when the claim is paid.

- **Claims Documents**

Claims under marine policies have to be supported by certain documents which vary according to the type of loss as also the circumstances of the claim and the mode of carriage. The documents required for particular average claims are as under :

- Policy,
- Bill of Lading,
- Invoice,
- Survey report,
- Debit Note,
- Copy of Protest,
- Letter of Subrogation,

Some of the other documents required in support of particular average claims are Ship survey report, lost over-board certificate if cargo is lost during loading and unloading, short landing certificate etc.

The other important documents are bill of entry issued by the customs authorities, account sales showing the proceeds of the sale of the goods if they have been disposed of; repairs or replacements bills in case of damages or breakage; and copies of correspondence exchanged between the carriers and the claimants for compensation in case of liability resting on the carriers.

Inland Transit Claims (Rail / Road)

In regard to claims relating to inland transit, the documents required to be submitted to the insurers in support of the claim are:

- Original policy or certificate of insurance duly endorsed.

- Invoice, in original, or copy thereof.
- Certificate of loss or damage (original) issued by carriers.
- If goods are totally lost or not delivered, the original railway receipt and / or non-delivery certificate / consignment note.
- Copy of the claim lodged againt the railways / road carriers.
- Letter of Subrogation, duly stamped.
- Special Power of Attorney duly stamped. (Railway Claims).
- Letter of Authority addressed to the railway authorities
- Letter of Undertaking from the claimant in case of non-delivery of consignment.

- **Recovery from Carriers**

In many marine claims, there are possibilities of recovery from the carriers, i.e., road carriers, railways, steamer companies, etc. After payment of claim, the insurers are subrogated to the rights and remedies available to the insured against the carriers or third parties responsible for the loss. The insured is expected to behave at all times as though he was uninsured. He should not, therefore, prejudice the rights of insurers in regard to recovery, and must take all steps to preserve such rights.

5. Understand the cover provided under Marine Hull Policy.

[Learning Outcome e]

Marine Hull Insurance covers only the loss or damage caused to the vessel. It does not cover loss or damage to the cargo carried by it

Example

A shipowner is transporting goods from one location to another, when an explosion severely damages the vessel and the cargo loaded thereon. Under the Marine Hull Insurance policy the shipowner will be entitled to compensation for the damage done to the vessel only and not the cargo.

Marine Hull insurance comprises the insurance of ocean going ships and other vessels such as fishing vessels, sailing vessels, inland vessels, etc. which are known as “Sundry Vessels”.

Hull insurance is generally granted on two basis viz. Time and Voyage – the former allows a cover for the respective interests on a time basis – maximum being twelve months and the latter covers designated voyage(s).

Under a Marine Hull policy cover is provided by attachment of Institute Time Clauses (Hulls) or Institute Voyage Clauses.

The Institute Time Clauses – Hulls (1.10.83) (ITC – Hulls)

These form the basis for most policies used for insurance of vessels and their machinery. There are variations to these clauses for specific purposes, but, in general all policies find their basis in the conditions set out in ITC – Hulls.

Coverage: Hull policies are named perils. The ITC Time Clauses – Hulls provide cover for loss or damage caused by:
(a) Perils of the seas, rivers, lakes or other nevigable waters.
(b) Fire, explosion
(c) Violent theft by persons from outside the vessel.
(d) Jettison
(e) Piracy
(f) Breakdown of or accident to nuclear installations or reactors.
(g) Contact with aircraft or similar objects.
(h) Earthquake, volcanic eruption or lightning.

Cover is also provided for:
(a) accident in loading, discharging or shifting of cargo or fuel
(b) bursting of boilers
(c) negligence of Master, Officers, Crew or Pilots.

Collision Liability: Legal liability the assured may incur by way of damages to the owners of any other vessel and cargo thereon, owing to a collision caused by the negligence of the insured vessel. The insurers agree to provide a supplementary cover to the assured over and above the insurance on the vessel itself, to extent of three-fourths of such liability.

Deductible: A specified deductible amount is applicable to claim(s) arising from each separate accident or occurrence, other than total loss or constructive total loss of the vessel.

Institute Time Clauses exclude war, strikes, malicious acts and nuclear risks.

The ship owner has insurable interest not only in the ship, but also in the freight to be earned during the period of insurance. Freight has been defined by the Marine Insurance Act, 1963 as follows:

"Freight includes the profit derivable by the Shipowner from the employment of his ship to carry his own goods or other movables, as well as freight payable by a third party, but does not include passage money". (Section 2(b).

If freight is payable on arrival of goods at destination the shipowner has insurable interest in the freight. If the ship or goods, in whole or part, are damaged by a peril insured against, the shipowner may suffer loss in respect of freight.

Freight may be insured by the shipowner voyage by voyage, or, for a period of time concurrently with the hull policy. Cover is provided by the Institute Time Clauses (Freight) and Institute Voyage Clauses (Freight).

In addition to freight the shipowner has insurable interest in the amount spent by him in fitting out the vessel, including provisions and stores. These expenses are termed disbursements and are insured concurrently with the hull policy for a period of time.

Hull policies are also issued to cover vessels in course of construction. These policies are taken by the shipbuilder. The vessels are insured from the laying of the keel. The cover is provided for all risks and the Institute Clauses for Builders Risks are used. The cover continues until completion of trials leading to delivery of the ship to the shipowners. Therefore, the policies are not on a fixed time basis.

Example

Total Loss: while at sea, a ship faces heavy weather and sinks.
Partial Loss: a ship catches fire and part of it is burnt.

- **War and Strike Risks:**

War and Strike risks in respect of hull and machinery and subsidiary interests i.e. freight, disbursements, etc. are covered under the Government of India War Risks Scheme which came into force from 1st July, 1976. It is a voluntary scheme so that it is left to each shipowner to opt for the scheme. The scheme is applicable to ships registered under the Indian Merchant Shipping Act, 1958.

Marine Hull Insurance also includes insurance of the following under separate sets of clauses formulated earlier by Tariff Advisory Committee:

a) Fishing Vessels / trawlers (mechanised or non-mechanised) engaged in fishing operations only.

b) Sailing Vessel may be mechanised or non-mechanised,
c) Inland Vessels of all types such as Barges, Pontoons, Flats, Floating Cranes, Launches, Passenger Vessels, Tugs and Port Crafts employed in Inland Waters.
d) A Dredger is a craft used to bring up sand, mud, gravel, etc. from the sea, river and canal bottoms in order to open and deepen channels and make them navigable. These crafts are fitted with the machinery and appliances for dredging work.
e) Jetties, Pontoons, Wharves, etc. in river, canal or sea waters.

- **Specialised Policies**

Ship Repairers Liability policy covers their legal liability for loss / damage to the vessel which is being repaired and loss / damage to machinery or equipment removed from the vessel for purpose of repairs.

Charterers' Liability policy covers the damage sustained by the vessel during the period of Charter for which the Charterers are held legally liable.

- **Off-Shore Oil / Gas Units Policy**

Specialised insurance policies are designed to cover units which are employed in connection with either exploration or for commercial production of oil / gas. Such policies cover drilling and production platforms, operations at site and also the transport of plant and equipment to the drilling sites.

Test Yourself 2

Question 2

____________expenses are incurred by the insured to minimise or avert a loss covered by the policy?

A. Sue and Labour Charges
B. Salvage Charges
C. Miscellaneous Charges
D. None of the Above

Summary

- A standard fire and special perils policy provides protection against loss due to fire and related perils.
- A standard fire and special perils policy can be modified and customised to suit a customer's requirement.
- Marine insurance policies are of 2 types: marine hull insurance and marine cargo insurance
- There are 4 types of losses under Marine Insurance: total loss, partial loss, sue and labour charges and salvage charges
- Marine policies based on the type of cover chosen, can be classified into 6 types: specific policy, open cover, open policy, special declaration policy, annual policy, duty and increased value policy.

Answers to Test Yourself

Answer to TY 1

The correct answer is **B**.

Replacement cost is paid for the property by the insurer under Reinstatement Value Policy.

Answer to TY 2

The correct answer is **A**.

Sue and Labour Charges are expenses that are incurred by the insured to minimise or avert a loss covered by the policy.

Self-Examination Questions

Question 1

Which type of fire policy covers stock at various locations under one sum insured?

A. Declaration policy
B. Floating policy
C. Long term policy
D. Consequential loss policy

Question 2

Which policy covers damage to actual structure of the vessel?

A. Marine cargo insurance
B. Marine hull insurance
C. Both of the above
D. None of the above

Question 3

Which policy provides cover for loss of gross profit due to stoppage of production?

A. Consequential loss policy
B. Long term policy
C. Reinstatement value policy
D. Declaration policy

Answer to Self-Examination Questions

Answer 1

The correct option is **B**

Floating policy covers stock at various locations under one sum insured.

Answer 2

The correct answer is **B**.

Marine hull insurance covers damage to actual structure of the vessel.

Answer 3

The correct answer is **A**

Consequential loss policy provides cover for loss of gross profit due to stoppage of production.

CHAPTER 4

GENERAL INSURANCE PRODUCTS – PART 2 (MOTOR, LIABILITY, PERSONAL ACCIDENT AND SPECIALTY INSURANCE)

Chapter Introduction

Motor insurance accounts for a major portion of the premium income of insurance companies in their miscellaneous class.

Liability insurance is a fast growing sector being driven by:

- consumer awareness
- globalisation
- international contracts
- increasing salaries
- improved legal services

Personal Accident and Health insurance covers cater to the needs of individuals whereas the specialty covers are for special situations demanding non-standard insurance product.

Learning Outcomes

a) Understand the cover provided under motor insurance policies,

b) Understand the basic underwriting and rating features

c) Understand the motor claims and procedures

d) Understand the cover provided under liability insurance policies

e) Understand the cover provided under personal accident, health and specialty policies

1. Understand the cover provided under motor insurance policies.

[Learning Outcome a]

1.1 Classification of vehicles:

For the purpose of insurance, motor vehicles are classified into three broad categories.

(a) Private cars

(b) Motor cycles and motor scooters

(c) Commercial vehicles, which are further classified into

- Goods carrying vehicles.
- Passenger carrying vehicles e.g. Motorised rickshaws, Taxis, Buses.
- Miscellaneous Vehicles, e.g.Hearses, Ambulances, Cinema Film Recording & Publicity vans,
  Mobile dispensaries etc.

Types of losses:

Two types of losses arise in respect of motor vehicles of all categories. They are:

- Loss of or damage to the vehicle (Own Damage or OD) and
- Third Party Liability (TPL) i.e. the legal liability for property damage and /or personal injury to third parties, arising out of use of the motor vehicle.

1.2 Compulsory insurance as per Motor Vehicles Act, 1988

The Motor Vehicles Act prescribes rules and regulations for licensing, use and insurance of all types of vehicles. It is, therefore, necessary to have some knowledge of Motor Vehicles Act (MV Act) which was originally passed in 1939 and amended in 1988.

In old days, many pedestrians who were knocked down or hit by motor vehicles and who were killed or injured did not get any compensation because the motorists did not have the resources to pay the compensation and were also not insured.

In order to safeguard the interests of pedestrians, therefore, the Motor Vehicles Act, 1939, introduced compulsory insurance against such damage to people.

The insurance of motor vehicles against own damage (i.e. damage to the vehicle itself) is not made compulsory, but the insurance of third party liability arising out of the use of motor vehicles in public places is made compulsory. As per this provision of the MV Act no motor vehicle can ply on road or in a public place without such insurance. Motor insurance policy for such compulsory insurance is called "Act Only" policy.

The liabilities which require compulsory insurance are as follows:

(a) any liability incurred by the insured in respect of death or bodily injury of any person including owner of the goods or his authorised representative carried in the carriage,

(b) liability incurred in respect of damage to any property of a third party,

(c) liability incurred in respect of death or bodily injury of any passenger of a public service vehicle,

(d) liability arising under Workmen's Compensation Act, 1923 in respect of death or bodily injury of
   (i) paid driver of the vehicle;
   (ii) conductor, or ticket examiner (Public service vehicles);
   (iii) workers, carried in a goods vehicle;

(e) liability in respect of death or bodily injury of passengers who are carried for hire or reward or by reason of or in pursuance of contract of employment.

The policy of insurance should cover the liability incurred in respect of any one accident as follows :

(a) In respect of death of or bodily injury to any person: The amount of liability incurred (without limit). This amount is generally awarded by the Motor Accidents Claims Tribunal on merits of each case.

(b) In respect of damage to any property of third party: A limit of Rs.6,000/-.

The liability in respect of death of or bodily injury to any passenger of a public service vehicle in a public place is the amount of liability incurred. (without limit).

Section 140 of the Motor Vehicles Act 1988, provides for liability of the owner of the Motor Vehicle to pay compensation in certain cases, on the principle of no fault.

The amount of compensation, so payable, is Rs.50,000/- for death, and Rs.25,000/- for permanent disablement of any person resulting from an accident arising out of the use of the motor vehicle.

(**Note:** The principle of "no fault" means the claimant need not prove negligence on the part of the motorist. Liability is automatic.)

1.3 Motor insurance important documents

Certificate of Insurance

In motor insurance, in addition to the policy a certificate of insurance is required by the Motor Vehicles Act. This certificate provides evidence of insurance to the Police and Registration authorities (R T O). It contains the essential features of the cover, including the terms and conditions.

The Motor Vehicles Act provides that the policy of insurance shall be of no effect unless and until a certificate of insurance in the form prescribed under the Rules of the Act, is issued. Certificate of insurance issued by the insurers is the only evidence of existence of a valid insurance as required by the Motor Vehicles Act & acceptable to the police authorities and R.T.O.
The points covered under a certificate of insurance differ according to the type of vehicle insured. The items of information included in a certificate of insurance are as under:

(1) Registration mark and number, or description of the Vehicles insured / Cubic capacity / carrying capacity / Make / Year of manufacture, Engine No., Chassis No.
(2) Name and Address of the Insured.
(3) Effective date and time of commencement of insurance for the purpose of the Act. Time……, Date……
(4) Date of expiry of insurance.
(5) Persons or classes of persons entitled to drive.
(6) Limitations as to use.
(7) Additional risks, if any
(8) Special conditions

Cover Notes:

A cover note is a document issued in advance of the policy. It is issued when the policy cannot for some reason or the other, be issued straightaway.

Cover notes are issued when the negotiations for insurance are in progress and it is necessary to provide cover on a provisional basis or when the premises are being inspected for determining the actual rate applicable. Pending preparation of the policy, the cover note is issued as evidence of protection for a temporary period of time and to prove that cover is in force. The cover note is temporary and will be superseded once the policy is issued. Sometimes, insurers issue a letter confirming the cover instead of cover note.

Although the cover note is not stamped, it nevertheless represents the same insurance as that provided by the policy. In fact, the wording of the cover note makes it clear that it is subject to the usual terms and conditions of the insurers' policy for the class of insurance concerned. Motor cover notes are to be issued in the form prescribed by the Motor Tariff. The operative clause of a motor cover note reads as follows:

"The Insured described in form 2 referred to below, having proposed for insurance in respect of the Motor Vehicle(s) described therein and having paid the sum of Rs….as premium the risk is hereby held covered under the terms of the company's usual form of……Policy applicable thereto (subject to any Special Conditions mentioned below) unless the cover be terminated by the Company by notice in writing in which case the insurance thereupon will cease and a proportionate part of the premium otherwise payable for such insurance will be charged for the time the company had been on risk."

The Motor Cover Note incorporates a certificate to the effect that it is issued in accordance with the provisions of Chapters X and XI of the Motor Vehicles Act, 1988.

The tariff regulations provide that a cover note is valid for a period of 15 days from the date of its issue. They further provide that if for any reason the insurer is not able to issue a policy during that period, the validity of the Cover Note may be extended for a further period of 15 days at a time, but in no case the total period of validity of a Cover Note shall exceed two months.

Renewal Notice

Although there is no legal obligation on the part of insurers to advise the insured that his policy is due to expire on a particular date, yet, as a matter of courtesy and healthy business practice, insurers issue a Renewal Notice one month in advance of the date of expiry, inviting renewal of the policy.

It is the practice to include in the renewal notice, a note advising the insured that he should intimate any material alterations in the risk. In Motor renewal notice, for example, the insured's attention is drawn to revise the sum insured in the light of current market value. The insured's attention is also invited to the statutory provision that no risk can be assumed unless the premium is paid in advance.

1.4 Types of policies

For all classes of vehicles, there are two types of Policy Forms:

Form "A"	To cover Act Liability. It is also known as Act Only Policy
Form "B"	To cover Own Damage Losses and Act Liability. It is also known as Comprehensive Policy

Form "A" is called "Standard Form for 'A' Policy for Act Liability". This form applies uniformly to all classes of vehicles, whether Private Cars, Commercial Vehicles, Motor Cycles or Motor Scooters, with suitable amendments in "Limitations as to Use".

Form "B", which provides wider cover as indicated above, varies with the class of vehicle covered. There are, therefore, Form "B" Policies for Private Cars, Commercial Vehicles, Motor Cycles/Scooters, etc.

A. Policy 'A' – Act only policy

This policy covers Liability to Third Parties as per following broad provisions:

1) In the event of an accident caused by or arising out of the use of the insured vehicle against all sums which the insured shall become legally liable to pay in respect of:
   i) death of or bodily injury to any person including occupants carried in the insured vehicle (provided such occupants are not carried for hire or reward) but except so far as it is necessary to meet the requirements of Motor Vehicles Act, (the insurer shall not be liable where such death or injury arises out of and in the course of the employment of such person by the insured),

ii) damage to property other than property belonging to the insured or held in trust or in the custody or control of the insured.

Provided always that the insurer shall not be liable in respect of death, injury or damage caused or arising beyond the limits of any carriageway or thoroughfare in connection with the bringing of the load to the vehicle for loading thereon or the taking away of the load from the vehicle after unloading there from.

2) The insurer will pay all costs and expenses incurred with its written consent.

3) In terms of and subject to the limitations of the indemnity granted by this section to the insured, the insurer will indemnify any driver who is driving the vehicle on the insured's order or with insured's permission provided that such driver shall as though he/she was the insured observe fulfill and be subject to the terms exceptions and conditions of this Policy in so far as they apply.

4) In the event of the death of any person entitled to indemnity under this Policy the insurer will in respect of the liability incurred by such person indemnify his/her personal representative in terms of and subject to the limitations of this Policy provided that such personal representative shall as though such representative was the insured observe fulfill and be subject to the terms exceptions and conditions of this Policy in so far as they apply.

5) The insurer may at its own option
   a) arrange for representation at any Inquest or Fatal Inquiry in respect of any death which may be the subject of indemnity under this Policy and
   b) undertake the defence of proceedings in any Court of Law in respect of any act or alleged offence causing or relating to any event which may be the subject of indemnity under this Policy.

Important Exceptions

The insurer shall not be liable in respect of:

1) Any accidental loss damage and/or liability caused sustained or incurred outside the Geographical Area.

2) Any claim arising out of any contractual liability.
3) Any consequential loss
4) a) any liability of whatsoever nature directly or indirectly caused by or contributed to by or arising from ionising radiations or contamination by radioactivity from any nuclear fuel or from any nuclear waste from the combustion of nuclear fuel. For the purposes of this exception combustion shall include any self-sustaining process of nuclear fission.
   b) any accidental loss or damage or liability directly or indirectly caused by or contributed to by or arising from nuclear weapons material
5) Any accidental loss damage and/or liability directly or indirectly or proximately or remotely occasioned by or contributed to by or traceable to or arising out of or in connection with war, invasion, the act of foreign enemies, hostilities or warlike operations (whether before or after declaration of war), civil war, mutiny rebellion, military or usurped power or by any direct or indirect consequences of any of the said occurrences and in the event of any claim hereunder the Insured shall prove that the accidental loss damage and/or liability arose independently of and was in no way connected with or occasioned by or contributed to by or traceable to any of the said occurrences or any consequences thereof and in default of such proof the insurer shall not be liable to make any payment in respect of such a claim.

(Note: Perils listed in item 4 are called nuclear perils and those in item 5 are called war & kindered perils)

Major Conditions

Any word or expression to which a specific meaning has been attached in any part of this Policy shall bear the same meaning wherever it may appear.

1) Notice shall be given in writing by the insured to the insurer immediately upon occurrence of any accident or loss or damage and thereafter the insured shall give all such information and assistance as the insurer shall require.
   Every letter, claim, writ, summons and/or process or copy thereof shall be forwarded to the insurer immediately on receipt by the insured.
   Notice shall also be given in writing to the insurer immediately the insured shall have knowledge of any impending prosecution, inquest or fatal injury in respect of any occurrence which may give rise to a claim under this Policy.

2) No admission offer promise payment or indemnity shall be made or given by or on behalf of the Insured without the written consent of the insurer which shall be entitled if it so desires to take over and conduct in the name of the Insured the defence or settlement of any claim or to prosecute in the name of the Insured for its own benefit any claim for indemnity or damages or otherwise and shall have full discretion in the conduct of any proceedings or in the settlement of any claim and the Insured shall give all such information and assistance as the insurer may require.

B. Policy 'B' Comprehensive Policy

This policy provides the so-called 'comprehensive' cover and the structure of the policy form is the same for all vehicles, (with some differences which are pointed out, wherever applicable)

Section I – Loss or Damage (or 'Own Damage')

The risks covered are:

a) Fire, explosion, self-ignition or lightning.
b) Burglary, house breaking or theft.
c) Riot and strike.
d) Earthquake (fire and shock damage)
e) Flood, typhoon, hurricane, storm, tempest, inundation, cyclone, hailstorm, frost.
f) Accidental external means.
g) Malicious act.
h) Terrorist activity.
i) Transit by road, rail, inland waterway, lift, elevator or air.
j) Landslide / rockslide.

Exclusions

(i) Consequential loss;
(ii) Depreciation;

(iii) Wear and tear; and
(iv) Mechanical or electrical breakdowns, failures or breakages.
(v) Damage to tyres unless the vehicle is damaged at the same time. (Then, 50% of cost of replacement payable). For commercial vehicles, see Compulsory Excess Clause dealt with later.
(vi) Loss when the vehicle is driven under the influence of intoxicating liquor or drugs.

(**Notes:**

1. In the motor cycle and commercial vehicle policy there is an additional exclusion:
   - Loss of or damage to accessories by burglary, housebreaking or theft unless the vehicle is stolen at the same time.
2. In commercial vehicle policy, there is a further exclusion :
   - Damage caused by overloading or strain of the vehicle.

Towing Charges

If the motor car is disabled as a result of damage covered by the policy, the insurers bear a reasonable cost of protecting the car and removing it to the nearest repairers, as also the reasonable cost of re-delivery to the insured. The amount so borne by the insurers is limited to Rs.2,500/- in respect of any one accident.
(**Note:** For motor cycles this limit is Rs.300/- and for commercial vehicles Rs.2500/-).

Repairs

Ordinarily repairs arising out of damage covered by the policy can be carried out only after they are authorised by the insurers. However, the insured is allowed to carry out the repairs without such authorisation, provided:

(a) the estimated cost of such repair does not exceed Rs.500/- (Rs.150/- for motor cycles).
(b) the insurers are furnished forthwith with a detailed estimate of the cost; and
(c) the insured gives the insurers every assistance to ensure that such repair is necessary and that the charge is reasonable.

Compulsory Excess

This applies only to commercial vehicles. The insured has to bear Rs.1500/- in respect of each accident. Further loss / damage to lamps, tyres, mudguards and / or bonnet side parts, bumpers and / or paintwork is not payable except in the case of a total loss of vehicle.

Section II – Liability to Third Parties

The insurers indemnify the insured against all sums which he may become legally liable to any person including occupants carried in the motor car provided that they are not carried for hire or reward by reason of death or bodily injuries caused to such third parties or by reason of damage to the property of third parties caused by or arising out of the use of the motor car.

The insured's liability for damage to property of third parties is limited to a specified amount; whilst liability for death of or bodily injury to third party is unlimited.

The legal costs and expenses incurred by such third parties are reimbursed in addition. The legal costs and expenses incurred by the insured are also reimbursed provided that they were incurred with the insurer's written consent.
The insurers are liable for the death of or bodily injury arising out of and in the course of employment, but only to the extent necessary to meet the requirements of the Motor Vehicles Act. The damage to property is not paid for, if the damaged property belonged to the insured or was held in trust by him or was in the custody or control of the insured.
(Note: This section is, more or less, the same for all vehicles, subject to some variations for motor cycles and commercial vehicles)

Section III

(This appears in commercial vehicle policies only.
This section provides cover while the vehicle is towing one disabled mechanically – propelled vehicle. It provides that whilst the insured vehicle is being used for the purpose of towing any one disabled, mechanically propelled vehicle

(a) the cover provided by the policy remains operative, and

(b) under Section II of the policy, indemnity will also be provided for the liability in connection with such towed vehicle. This however is subject to the following two provisos :

(i) The towed vehicle should not be towed for hire or reward and

(ii) No cover is available under the policy for the damage to the towed vehicle or the property conveyed thereby.

General Exclusions (applicable to all sections)

These provide that the insurer shall not be liable in respect of:

(a) Any accident outside the geographical area specified in the policy, that is, India.

(b) Contractual liability.

(c) Any accident when the vehicle is used not in accordance with the Limitations as to Use clause.

(d) Any accident when the vehicle is driven without an effective driving licence (Driver's Clause).

(e) War and nuclear risks.

Conditions

Apart from the usual conditions such as notice of loss, cancellation of policy, arbitration, etc. there are two conditions which are specific to motor policies.

- The insured is required to safeguard the vehicle from loss or damage and maintain it in efficient condition. In the event of an accident, the insured shall take precautions to prevent further damage. If the vehicle is driven before repairs any further damage is at insured's risk.
- The insurer has the option to repair or replace the vehicle or parts or pay in cash the amount of damage or loss. The insurer's liability cannot exceed the insured's estimated value of the vehicle (specified in the policy) or the value of the vehicle at the time of loss whichever is less.

Test Yourself 1

Question 1

Under motor insurance ambulances will be classified under which class?

A. Goods carrying vehicles
B. Passenger carrying vehicles
C. Miscellaneous vehicles
D. Private vehicles

2. Understand the basic underwriting and rating features. [Learning Outcome b]

Rating

The proposal form elicits all information necessary for rating and underwriting. Some examples of rating are given:

Private Cars
Rates for Own Damage are based upon
i) The cubic capacity (CC) as given by manufacturers,
ii) Insured Estimate of Value (IEV) and
iii) The Zone or area of operation.
The cubic capacity of the car indicates power of the engine. Separate rates apply for CC below 1500 and CC over 1500.

'Act' Policy Premium: This premium is again dependent upon the cubic capacity of the vehicle and is not a rate but lump sum amounts. Higher the CC, higher the rate.

Motor Cycle & Scooters
The rates depend upon C.C. and Insured Estimated Value (IEV).

Buses
The rates depend upon C.C., IEV and capacity by number of passengers (Foe 'Act' cover premium is normally expressed per passenger.

Goods Carrying Vehicles

The rates are based on Gross Vehicle Weight (GVW) which means the total weight of the vehicle and load certified by the registering authority as permissible for that vehicle and IEV.

Extra Benefits

Some examples of benefits availabe at extra premium are:
All Vehicles:

(a) Increased third party property damage limits i.e. over Rs.6,000/-.
(b) Wider legal liability to persons e.g. paid drivers etc. employed in operation and / or maintenance of the vehicle i.e. under W.C. Act and at common law.

Private Cars

(a) Extra fittings like radios, tape-recorders, air conditioners etc. (Also applicable to commercial vehicles)
(b) Reliability Trials and Rallies in India (Also applicable to motor cycles).

Discounts (some examples)

(a) Voluntary excess under Own Damage Section – (Applicable to all vehicles).
(b) Membership of recognised Automobile Association (Private cars & motor cycles).
(c) Deletion of Riot, Strike, etc., Earthquake, Flood. (All vehicles).

Bonus / Malus

A discount in the premium is allowed at renewal if there is no claim during the policy year or a loading in the premium is charged if there is a claim. Separate scales are provided for private cars and taxis and other vehicles.
The discount for good claims experience of the insurers is termed as ‘Bonus’ wnd the loading for adverse claims ratio is called “Malus”.

Underwriting

There are several factors which are important for underwriting such as

(a) type of vehicle e.g. imported cars, sports cars,
(b) use of the vehicle,
(c) geographical area etc.
(d) age of the vehicle, which is the most important factor.

Generally, the approach of insurers is as follows:

Private Cars

Age of the vehicle	**Cover**
over 15 years old	Act only
between 10 years & 15 years	Comprehensive cover subject to satisfactory inspection report.
Upto 10 years	Comprehensive cover

Taxies & Public Carriers

Taxies	**Public Carriers**	**Cover**
Upto 3 years old	Upto 5 years old	Comprehensive cover
Upto 5years old	Upto 6 years old	Comprehensive subject to inspection
5 to 7 years old	6 to 7 years old	Subject to inspection and additional excess
Over 7 years	Over 7 years	Act cover only.

Some important rules:

Important rules followed by insurers are as follows:

(a) 'Agreed Value' policies are not allowed except for vintage cars.
(b) Policies have to be issued in the name of the registered owner only. In the case of hire purchase agreements, policies must be issued in the name of the hirer and the owner's interest protected by attaching to the policy the prescribed endorsement.
(c) The prescribed cover note should be used when full details e.g. vehicle registration number etc. are not available. The cover note incorporates a certificate of insurance. The cover note is valid for 15 days and can be extended upto a maximum period of two months.

(d) Prescribed procedure for issue of a duplicate certificate when the original is lost, torn, defaced, etc.

(e) Concessions e.g. return of premium, restricted cover, etc. when the vehicle is laid up in garage and not in use for a period of two consecutive months or more.

Detariffication

In 2007, the old tariff rating system was disbanded in respect of Motor Own Damage (it could have included Third Party as well but Trade Unions / Truckers' protest prevented that).

Test Yourself 2

Question 2

In private motor insurance separate rates apply for vehicles below and above _________-

A. 2000 CC
B. 1800 CC
C. 1500 CC
D. 1200 CC

3. Understand motor claims and procedures. [Learning Outcome c]

3.1 Own Damage Claims

On receipt of notice of loss, the policy records are checked to see that the policy is in force and that it covers the vehicle involved. The loss is entered in the Claims Register and a claim form is issued to the insured for completion and return.

The insured is required to submit a detailed estimate of repairs from any repairer of his choice. Generally, these repairs are acceptable to the insurers but they at times ask the insured to obtain repair estimate from another repairer, if they have reason to believe that the competence, moral hazard or business integrity of the repairer first chosen in not satisfactory.

3.2 Assessment

Independent automobile surveyors are assigned the task of assessing the cause and extent of loss. They are supplied with a copy of the policy, the claim form and the repairer's estimate. They inspect the damaged vehicle, discuss the cost of repair or replacement with the repairer and submit their survey report.
In respect of minor damage claims, independent surveyors are not always appointed. The insurer's own officials or their own automobile engineers inspect the vehicle and submit a report.

3.3 Settlement

The survey report is examined and settlement is effected in accordance with the recommendations contained therein. The usual practice is to authorise the repairs directly with the repairer to whom a letter is issued to that effect.

In this letter the repairers are also instructed to collect direct from the insured the amount of the Excess, if applicable to the claim, before delivering the repaired vehicle to him. The repairers are also instructed to keep aside the salvage of damaged parts, if there are any, for being collected by the salvage buyer nominated by the Insurers.
Or else, if the repairers are willing to retain the salvage, its value, as indicated by the surveyor, is deducted from the claim bill.

On receipt of their final bill of repairs after completion of repairs and a satisfaction note or voucher from the insured that the vehicle has been repaired to his satisfaction, the payment to the repairer is effected.
Sometimes, the repairer is paid directly by the insured in which case the latter is reimbursed on submission of a receipted bill from the repairers.

In either case, discharge voucher or receipt is obtained.
The Claims Register and the policy and renewal records are marked that the claim is paid indicating the amount of claim and the amount of salvage, if any.

3.4 Total Loss Claims

Whenever a surveyor finds that a vehicle is either beyond repairs or the repairs are not an economic proposition, he negotiates with the insured to assess the loss on a Total Loss basis – for a reasonable sum representing the market value of the vehicle immediately prior to the loss.

If the market value is more than the insured value, the settlement will be brought about for the insured value, the settlement will be brought about for the insured value. The Insured will be paid in cash and the Insurers will take over the salvage of the damaged vehicle which will thereafter be disposed of for their own benefit calling tenders through advertisements in newspapers.

However, before the actual payment is made to the Insured, the Insurers will collect from him the Registration and Taxation books, ignition keys and blank TO. and T.T.O. forms duly signed by the insured, so that the salvage can be transferred in the name of the salvage buyer.

If the vehicle is beyond repairs and has to be scrapped the R.C.Book and the keys will have to be returned to the Registering Authority for cancellation.

3.5 Theft Claims

Total losses can also arise due to the theft of the vehicle and its remaining untraced by the police authorities till the end. These losses will have to be supported by a copy of the First Information Report lodged with the Police authorities immediately after the theft has been detected.

The police authorities register the complaint allotting it a number of the entry made in the Station Diary. This number which is usually known as SDE Number. (Station Diary Entry) or C.R. Number.(Crime Register) has to be quoted by the Insured in the claim intimation to the Insurers.

The police keep the investigations going until the vehicle is traced and delivered to its owner.

However, if they do not succeed in recovering the vehicle after a period of, say 3-4 months, they file away the case certifying that the case is classified as true but undetected. This certificate is essential before a total loss following theft is settled by the insurers.

If the R.C. Book and Taxation Certificate are also stolen along with the vehicle, it will be necessary for the insured to obtain duplicate ones from the Registering Authority and thereafter deposit them with the Insurers.

The only additional documents will be letter addressed by the Insured to the R.T.O. informing about the loss of the vehicle due to theft and filing a Non User Form so that he is not made liable to pay the taxes.

Some insurers also obtain from the insured a special type of a Discharge on a stamped paper whereby the Insured undertakes to refund the claim amount if the vehicle is subsequently traced and delivered to him by the police. He also undertakes in the Discharge Form to pay any taxes which may be outstanding against the stolen vehicle. The ignition keys, R.C.Books etc. are preserved by the Insurer in their custody so that these are made readily available if the vehicle is traced at a later date.

It is always prudent to inform the concerned Registering Authority by a Registered A/D letter that a total loss claim is being processed for payment in respect of the stolen vehicle and to request them not to transfer the ownership of the vehicle to anyone. This will prevent the thief from disposing of the stolen vehicle.

3.6 Claims Documents

Apart from claim form and Survey report the other documents required for processing the claim are:

(1) Driving Licence
(2) Registration Certificate Book
(3) Fitness Certificate (Commercial Vehicles)
(4) Permit (Commercial Vehicles)
(5) Police Report
(6) Final Bill from repairers
(7) Satisfaction Note from the insured
(8) Receipted bill from the repairer, if paid by insured.

3.7 Third Party Claims

Section 165 of the Motor Vehicles Act 1988, empowers the State Governments to set up Motor Accident Claims Tribunals for adjudicating upon third party claims. When a tribunal has been set up for an area, no civil court has any jurisdiction to entertain any claim falling under the tribunal's jurisdiction.

The aggrieved party has to move the tribunal within a period of six months from the date of accident.
While making the award, the tribunal has to specify the amount payable by the insurer.

The procedure for third party claims is briefly described below:

On receipt of notice of claim from the insured, or the third party or from the MACT, the matter is entrusted to an advocate.

Full information relating to the accident is obtained from the insured. The various documents are collected and these include

- Driving licence,
- Police report
- Details of driver's prosecution, if any
- Death certificate, coroner's report, if any (fatal claims).
- Medical certificate (bodily injury claims)
- Details of age, income and number of dependants etc.

A written statement is then filed on the facts of the case with the MACT by the advocate. Eventually, if the award is made by the MACT, the amount is paid directly to the third party against proper receipt.

3.8 Compromise Settlements

Where there is clear liability under the policy, claims are negotiated with the third party to accept a compromise settlement, which if accepted by the third party, is registered with the MACT and its consent obtained. The cheque is deposited with MACT for disbursement to the rightful beneficiaries.

3.9 Lok Adalats

Pending cases with the MACT where the liability under the policy is not in doubt are placed before the Lok Adalat or Lok Nyayalaya, for a voluntary and amicable settlement between the parties. A copy of decision in the prescribed memo and the cheques is deposited with MACT. Lok Adalat sessions are organised regularly by the four companies in liasion with the Legal Aid Board of each State and MACT to effect amicable settlement of third party claims.

3.10 No Fault Liability

These claims are settled by depositing the appropriate amount with the MACT after obtaining death certificate, medical certificate and police report.

Test Yourself 3

Question 3

To process a motor insurance claim which of the below document/s are required?

A. Registration Certificate Book
B. Police Report
C. Driving Licence
D. All of the above

4. Understand the cover provided under liability insurance policies.

[Learning Outcome d]

The word 'Liability' for the purpose insurance, relates to legal liability. There are four major legal liability policies:

- Public liability,
- Products liability,
- Professional indemnities and
- Employer's liability.

The subject matter of these policies is potential legal liability towards third parties or employees, as the case may be. If legal liability is incurred, there will be financial losses in the form of damages or compensation.

4.1 Compulsory Public Liability Policy

The Public Liability Insurance Act, 1991 requires that any undertaking which handles hazardous substances, has to compulsorily insure liability for an amount not less than the amount of the paid up capital of the undertaking. If it is not a company, paid up capital means the market value of all assets and stocks of the undertaking on the date of contract of insurance. The Act imposes no fault liability (i.e. irrespective of any wrongful act, neglect or default) on the owner to pay relief in the event of

(a) Death of or injury to any person (other than a workman within the meaning of Workmen's Compensation Act); or

(b) Damage to property of any person arising out of an accident while handling any hazardous substance.

No fault liability means the claimant is not required to prove that the death, injury or damage was due to any wrongful act neglect or default of any person.

The Act prescribes under Section 3 the amount of relief payable is as per the following schedule:

- i) Fatal Accident – Rs.25,000/- per person
- ii) Permanent Total disability - Rs.25,000/- per person
- iii) Permanent Partial disability: The amount of relief is based on the percentage of disablement certified by an authorised physician i.e., a registered medical practitioner.
- iv) Temporary partial disablement which reduces the earning capacity of the victim. Fixed relief not exceeding Rs.1,000/- per month upto a maximum of 3 months (provided the victim has been hospitalised for a period exceeding 3 days and is above 16 years of age).
- v) Actual Medical Expenses: Upto a maximum of Rs.12,500 in each case under (i) to (iv) above.
- vi) Actual damage to property upto Rs.6,000/-.

The following definitions of the Act are important:

“Handling” in relation to any hazardous substance means the manufacture, processing, treatment, packaging, storage, transportation by vehicle, use, collection, destruction, conversion, offering for sale, transfer or the like of such hazardous substance.

“Hazardous Substances and Group” means the items listed and grouped under Public Liability Insurance Act 1991 and the Rules framed thereunder.

“Turnover” shall mean –

(i) Manufacturing units – Entire Annual Gross Sales Turnover including all levies and taxes of manufacturing units handling hazardous substances as defined in the Public Liability Act, 1991.

For the purpose of this insurance, the term “Units” shall mean all operations being carried out in the manufacturing complex in one location.

(ii) Godowns and Warehouse owners – Total Annual Rental Receipts of premises handling hazardous substances as defined in the Public Liability Insurance Act, 1991.

(iii) Transport operators – Total Annual Freight receipts.

(iv) Other – Total Annual gross receipts.

The policy provides for indemnity to the insured owner against the statutory liability arising out of accidents occurring during the currency of the policy due to handling hazardous substances as provided for in the Act.
The rates of premium are based on limit of indemnity (any one accident) and the turnover.

(Note: An amount, equal to the premium has also to be paid to the insurers, as contribution to the Environment Relief Fund, set up by the government. This fund pays relief when it exceeds the amount payable under the policy)
Application for claim for relief must be made by the affected party, within 5 years of occurrence of the accident, to the Collector who shall hold an enquiry and make an award. The insurer is required to deposit the award with the Collector within 30 days of announcement of the award.

4.2 Public liability policy (industrial / non-industrial risks)

Industrial Risks are manufacturing premises including godowns, warehouses etc., forming part thereof.

Non-Industrial Risks are:
(i) Hotels, Motels, Club houses, Restaurants, Boarding and Lodging houses, Flight kitchens.
(ii) Cinema Halls, Auditoriums, Theatres, Public Halls, Pandals, Open air theatres.
(iii) Residential premises.
(iv) Office / Administrative premises, Medical establishments, Airport premises (other than aviation liabilities), Research Institutes and laboratories.
(v) Schools, Educational Institutions, Public libraries.
(vi) Exhibitions, fairs and fetes, stadia.
(vii) Permanent amusements parks.
(viii) Film studios – indoor and outdoor, Circus, Zoos.
(ix) Depots, Warehouses, Godowns, Shops, Tank farms and
(x) similar other non-industrial risks

Cover

The policy indemnifies the insured
- against their legal liability
- other than liability under the Public Liability Insurance Act, 1991, or any other statute that may come into force after the issue of the Policy.
- to pay compensation including claimant's costs, fees and expenses.
- anywhere in India in accordance with Indian Law and
- in respect of accidents which cause death or injury or damage to property of third parties.

The indemnity only applies to claims
(a) arising out of accidents during the **period of insurance** and
(b) first made in writing against the insured during the **policy period**.
'Policy Period' means the period shown in the Policy Schedule a (for example, the period may commence at 00 hrs. on 1.1.2011 and expire at midnight on 31.12.2011)

'Period of Insurance' means the period commencing from the retroactive date and terminating on the expiry date as shown in the Policy Schedule. For example- if the policy period is from 1-1-2010 to 31-12-2010 and the policy renewed from 1-1-2011 to 31-12-2011 then under the renewed policy the retroactive date will be 1-1-2010 which date will continue in further renewals
The indemnity clause excludes liability in respect of:
(a) Products (This can be covered under a separate policy explained later)
(b) Pollution (Can be covered on payment of extra premium)

The other important exclusions are:
(a) transportation of hazardous substances (can be covered on at extra premium)
(b) injuries to employees (this can be covered under a separate workman's compensation policy)

Limits of Indemnity

The insured has to select limits of indemnity
a. any one accident (A.O.A.) and
b. any one year (A.O.Y.) (policy period)

in the ratio of 1:1, 1:2, 1:3 or 1:4.
Example; **A.O.A.** Rs.10 lacs,
A.O.Y. Rs.10 lacs or Rs.20 lacs or Rs.30 lacs or Rs.40 lacs

Excess

The insured has to bear compulsory excess of 0.50% of the limit of indemnity, any one accident (Minimum Rs.2000/-, Maximum Rs.3 lacs).
Under non-industrial risks it is 0.25% (Minimum Rs.1,000/-, Maximum Rs.1 lac)
Over and above this excess the insured can opt for voluntary excess for which discounts are granted in the premium.

Premium

The rates of premium, for industrial risks depend upon
(a) Risk group
(b) The limit of indemnity, A.O.A.
(c) The ratio of A.O.A. limit to A.O.Y. limit.
(d) Turnover.

Risks are categorised into 4 groups depending upon the hazard factors involved. Some examples are:
Group I: Biscuit factories, Coir factories, Glass & Ceramic factories, Silk factories etc.
Group II: Breweries, Cigarette factories, Shoe factories, Sugar factories etc.
Group III: Distilleries, Manmade yarn / fibre manufacturing, paper and cardboard mills.
Group IV: Celluloid goods manufacturing, Fertilizer manufacturing, Match factories, etc.
(Note: The rates are the lowest for Group I risks and increase scale for the other groups)

4.3 Product liability policy

The demand for products liability insurance has arisen because of the wide variety of products (e.g. canned food stuff, medicines & injections, electrical appliances, mechanical equipment, acids & chemicals, etc.) manufactured and sold to public in the modern industrial society. If defective, these products may cause death, bodily injury or illness or even damage to property.

An increasing consciousness on the part of the public, of their legal rights and remedies and the emergence of consumer protection movement in the country have further contributed to the demand for this class of insurance.
The indemnity only applies to for and / or arising out of injury Damage or Pollution claims during the period of insurance and first made in writing against the insured during the policy period arising out of any defects in the products specified in the schedule. The policy does not cover liability for claims.

i. for costs incurred in the repair, reconditioning, modification or replacement of any part of any product which is or is alleged to be defective.
ii. arising out of any product guarantee.
iii. arising out of failure of the goods or products to fulfill the purpose for which they were intended.
iv. for costs arising out of the recall of any product or part thereof.

The compulsory excess is 0.50% of the A.O.A. limit but for exports to U.S.A., and Canada it is 1% with a minimum of Rs.4000/-.

Premium

The rates of premium depend upon
(a) Class of risk (Products are classified into different groups)
(b) Turnover
(c) Limit of indemnity
(d) Ratio of limit of indemnity A.O.A. to A.O.Y.

Exports

Exports can be covered as an extension of the policy covering domestic sales or a separate policy can be issued only for exports.

Lift (Third Party) Insurance

The policy provides indemnity to owners of buildings in respect of liabilities arising out of the use and operation of lifts. The legal liabilities covered are in respect of:
a) Death / bodily injury of any person (excluding employees of the insured).
b) Damage to property (excluding insured's own or employee's property)

The premium rates depend upon the limit of indemnity, any one person, any one accident and any one year.

Professional Indemnities

Professional indemnities are designed to provide insurance protection to professionals such as doctors, solicitors, chartered accountants, architects etc. against their legal liability to pay damages arising out of negligence in performance of their professional duties.
Such professionals can be:
(a) doctors / medical practitioners;
(b) medical establishments;
(c) engineers, architects and interior decorators;
(d) chartered accountants, financial consultants, management consultants, and
(e) lawyers, advocates, solicitors and counsel.

The policies provide for limits of indemnity any one year and any one claim. Compulsory / Voluntary excess provisions also apply but not in doctors and medical establishments policies.

The overall structure of these policies is the same as under Industrial Risks Public Liability insurance policy, with many clauses, exclusions, conditions being in common. However, there are additional exclusions which are specific to each type of profession for example, Doctors policy exclude liability relating to Aids, Cosmetic surgery etc.
The rates of premium are charged on A.O.Y. limit.

Directors' and Officers' Liability Policy

This is a highly specialised type of insurance. Directors and Officers of a company hold positions of trust and responsibility. They may become liable to pay damages to shareholders, employees, creditors, etc. of the company, for wrongful acts committed by them in the supervision and management of the affairs of the company. The policy is designed to provide protection to Directors and Officers against their personal civil liability.

Employer’s Liability Policy

This is also known as Workmen’s Compensation Insurance.
The policy protects the employers against their legal liability for payment of compensation for death or disablement of the employees by accident or disease arising out of and in the course of employment. This liability may rise under Workmen’s Compensation Act, Fatal Accidents Act or Common Law.

Table ‘A’ cover: provides indemnity against legal liability under the Workmen’s Compensation Act, Fatal Accidents Act and Common Law. This may be issued for only those employees who come within the definition of ‘workmen’ under the Workmen’s Compensation Act.

Table ‘B’ cover: provides indemnity against legal liability under the Fatal Accidents Act and Common Law. This may be issued to cover only those employees who are not ‘workmen’ within the meaning of that term under the Workmen’s Compensation Act.

The policy does not specify any sum insured because the amounts of compensation stipulated in the Act/s or awarded by a court of law determine the limits of liability of the insurers.
Different rates of premium for different groups of trades.

Extensions

The policy can be extended, at extra premium to include
(a) certain diseases mentioned in the Act
(b) medical expenses
(c) liability for contractor's workmen.

Employees State Insurance

The passing of the Employees State Insurance Act in 1948 introduced social insurance in India. The objects of the Act are "to provide certain benefits to employees in cases of sickness, maternity, employment injury and to make provision for certain other matters in relation thereof". The Act provides for Employees State Insurance Corporation (ESIC), a statutory Corporation set up under the provision of the Act.

The scheme is applicable to industrial employees as defined in the Act. The Act operates in certain industrial areas as notified by the government from time to time.

Under the scheme a fund is maintained consisting of contributions from the employees, employers and the Government. From this fund the following expenses are met:

(1) Sickness benefit, maternity benefit, disablement benefit, dependence benefit (death) and medical treatment.
(2) Establishment and maintenance of hospitals, dispensaries, etc. for the benefit of the insured persons and their families.
(3) Administration of the Scheme.

Environmental Impairment Liability (E.I.L.)

Legal Liability for damages to environment arising from pollution.

Test Yourself 4

Question 4

The Employees State Insurance Act was enacted in which year?

A. 1942
B. 1947
C. 1948
D. 1950

5. Understand the cover provided under personal accident, health and specialty policies

[Learning Outcome e]

5.1 Personal Accident Insurance

The purpose of personal accident insurance is to pay fixed compensation for death or disablement resulting from accidental bodily injury.

The policy provides that, if at any time during the currency of this policy, the insured shall sustain any bodily injury resulting solely and directly from accident caused by external violent and visible means, then the company shall pay to the insured or his legal personal representative(s), as the case may be, the sum or sums set forth in the policy, if resulting in specified contingencies such as death, permanent disablement etc.

The following is a specimen table of benefits on the basis of sum insured of Rs.1 lac selected for the purpose of illustration only of the general approach.

Contingency

Amount of compensation payable

(a)	Death	Rs.1,00,000 (i.e. 100% of capital sum insured)
(b)	Loss of two limbs or both eyes or one limb and one eye.	Rs.1,00,000 (i.e. 100% of capital sum insured)
(c)	Loss of one limb or one eye	Rs.50,000 (i.e. 50% of capital sum insured)
(d)	Permanent total disablement other than the above (e.g. paralysis due to an accident)	100% of capital sum insured
(e)	Permanent partial disablement	Percentage as shown in the table in the policy
(f)	Temporary Total disablement	Weekly payment of Rs.1000/- (i.e. One percent of the capital sum insured) subject to a maximum of 100 weeks.

The amount of weekly payment is restricted to a maximum sum of Rs.3000/- whatever be the capital sum insured. This limit applies to all policies held by the insured.

Additional Benefits

(a) Expenses incurred for carriage of dead body of insured (death due to accident only) to place of residence are reimbursed subject to limits.
(b) In the event of death or permanent total disablement of the insured person, the policy provides for Education Fund for the dependent children, in addition to Capital Sum Insured.
(c) Compensation payable for death, loss of limb(s) or sight and Permanent Total Disablement is increased by 5% at each renewal of policy upto a maximum of 50% of sum insured.

Extensions

i. A personal accident policy can be extended by endorsement, on payment of extra premium to cover medical expenses incurred by the insured in connection with the accidental bodily injury, subject to specified limits.
ii. War risk cover can be granted to Indian personnel / experts working in foreign countries on civilian duties at additional premium.

Exclusions (Some examples)

(a) Suicide
(b) Influence of liquour or drugs.
(c) Service in armed forces
(d) Engaging in aviation except as passenger in licensed standard type of aircraft.

Group Personal Accident Policy (Group P A)

Group policies are issued where there is some common relationship among the persons to be insured and a central point for the administration of the insurance scheme. Accordingly, these policies can be granted only to groups clearly following under any one of the following categories:
(a) Employer – Employee relationship including dependants of the employee.
(b) Members of a registered co-operative society.
(c) Members of Registered Service Clubs etc.

5.2 Health Insurance

Mediclaim Insurance

The policy provides for reimbursement of hospitalisation expenses for illness suffered or accident sustained during the policy period. The policy is available to individuals and family members. The policy is also available to any group, association, or corporate body with a central administration point.

Exclusions (Some examples)

(a) Pre-existing diseases.
(b) Disease contracted during first 30 days of commencement of policy.
(c) Specified diseases (e.g. cataract, hernia, etc.) during first year of policy.
(d) Cost of spectacles, contact lenses, hearing aids.
(e) Venereal diseases, Aids.
(f) Pregnancy, Childbirth.

Overseas medical policy provides for payment of medical expenses for illness / accident during overseas travel for business, official or holiday purposes.

5.3 Specialty Covers

Product	Brief Description
Credit and Political Covers	This covers a client's bad debts and also the contingencies that might arise from actions of political nature
Cyber Risks	This is a collection of new covers ranging from denial of service through virus spread to loss following hacking – and a number of other covers as well
Entertainment / Films	This is a collection of covers ranging from film financing risks, through injury / death of key artistes to the property losses – and a number of other covers as well
Event Cancellation	This is a collection of covers ranging from cancellation of event, prize indemnity, loss of reputation of key presenter / attender – and a number of other covers as well

Title	Covers defective land title – can be from a number of reasons including defective rights of way, restrictive covenants and unclear title
Rural including crop covers	A number of covers including Personal Accident to the farmers, livestock cover, crop insurance (usually weather related)
Weather Derivatives	Sophisticated covers where traders such as ice-cream manufacturers may wish to take insurance against a cold summer or umbrella manufacturers against a dry monsoon
Carbon credits	Normally a derivation of Political / Credit covers where, say, a Government decision may impact a project and reduce the opportunity of the insured to benefit from Carbon Credit sales
Body parts e.g. Legs, Hands, Nose, etc.	Insurance taken by specialist entertainers, sportspersons, etc. where loss of / damage to a particular body part (legs of footballer, dancer) or voice of a singer will significantly impact their earning ability significantly
Spoilage, leakage / contamination of stocks	Relates to trades such as spirit or wine trade where contamination of the product will severely hit profits

Test Yourself 5

Question 5

Under Personal Accident Insurance, in case of loss of one limb or one eye, how much compensation will be payable?

A. 50% of capital sum insured
B. 75% of capital sum insured
C. 100% of capital sum insured
D. 25% of capital sum insured

Summary

- For the purpose of insurance, motor vehicles are classified into three broad categories: (a) private cars, (b) motor cycles and motor scooters and (c) commercial vehicles.
- The Motor Vehicles Act (1988) prescribes rules and regulations for licensing, use and insurance of all types of vehicles.
- Important documents in motor insurance include: certificate of insurance, cover notes, renewal notice etc.
- Form A policy form covers Act Liability. It is also known as Act only Policy
- Form B policy form covers Own Damage Losses and Act Liability. It is also known as Comprehensive Policy.
- In 2007 detariffication was introduced and the old tariff rating system was disbanded in respect of Motor Own Damage.
- Under liability insurance there are four major legal liability policies: (a) public liability, (b) product liability, (c) professional indemnity and (d) employer's liability.
- The purpose of personal accident insurance is to pay fixed compensation for death or disablement resulting from accidental bodily injury**.**
- Health insurance provides for reimbursement of hospitalisation expenses for illness suffered or accident sustained during the policy period.

Answers to Test Yourself

Answer to TY 1

The correct option is **C**

Under motor insurance ambulances will be classified under miscellaneous vehicles

Answer to TY 2

The correct option is **C**

In private motor insurance separate rates apply for vehicles below and above 1500 CC

Answer to TY 3

The correct option is **D**

To process a motor insurance claim all the 3 mentioned document/s are required: Registration Certificate Book, Police Report, Driving Licence

Answer to TY 4

The correct option is **C**

The Employees State Insurance Act was enacted in 1948

Answer to TY 5

The correct answer is **A**.

Under Personal Accident Insurance, in case of loss of one limb or one eye, 50% of the capital sum insured will be payable as compensation

Self-Examination Questions

Question 1

The Motor Vehicles Act was enacted in which year?

A. 1939
B. 1940
C. 1941
D. 1942

Question 2

Section 140 of the Motor Vehicles Act 1988, provides for liability of the owner of the Motor Vehicle to pay compensation in certain cases, on the principle of no fault. How much is the compensation payable for death in such cases?

A. Rs. 10,000
B. Rs. 25,000
C. Rs. 50,000
D. Rs. 1,00,000

Question 3

In case of motor insurance which document is considered as the only evidence of existence of a valid insurance by police authorities and R.T.O?

A. Policy document
B. Certificate of insurance
C. Cover notice
D. Insurance notice document

Question 4

In Motor Insurance, Form A Policy Form covers __________.

A. Act Liability
B. Own Damage Losses
C. Act Liability and Own Damage Losses
D. Only Third Party Losses

Answer to Self-Examination Questions

Answer 1

The correct option is **A**

The Motor Vehicles Act was enacted in 1939

Answer 2

The correct answer is **C**.

Under Section 140 of the Motor Vehicles Act 1988, the liability payable for death is Rs. 50,000 on the principle of no fault

Answer 3

The correct answer is **B**

In case of motor insurance, the certificate of insurance is considered as the only evidence of existence of a valid insurance by police authorities and R.T.O.

Answer 4

The correct answer is **A**.

In Motor Insurance, Form A Policy Form covers Act Liability.

CHAPTER 5

GENERAL INSURANCE PRODUCTS – PART 3 (ENGINEERING & OTHER INSURANCES)

Chapter Introduction

In the previous chapters, we had a look at the major classes of insurance covers like Fire, Marine, Motor, PA, Health. In this section we will deal with

a) Various classes of policies under Engineering Insurance, which is expanding rapidly and almost all non-life insurers have now a separate department to handle this portfolio,
b) Various other classes of insurance which take care of sectors like banks, jewellers, individuals etc. These are small policies in nature and hence, each company may use its own nomenclature as policy titles.

Learning Outcomes

a) Understand the cover under engineering insurance policies
b) Understand other insurance covers available under various categories

1. Understand the cover under engineering insurance policies

[Learning Outcome a]

Engineering Insurance

This class of insurance provides different policies for insurance needs during construction and operational phase of a project. Brief details of major classes are given below for reference:

1.1 Contractors All Risks (C.A.R.) Policy

This policy is designed to protect the interests of contractors and principals in respect of civil engineering projects, like buildings, bridges, tunnels, etc.

The policy provides an "All Risk" cover. Every risk is covered which is not specifically excluded. This means that almost any sudden and unforeseen loss or damage occurring during the period of insurance to the property insured on the construction site is indemnified. The more important causes of losses indemnifiable under CAR Insurance are:

- Fire, lightning, explosion
- Flood Inundation
- Windstorm of any kind
- Earthquake, Landslide, Subsidence, etc.
- Theft & Burglary
- Accidental damage, bad workmanship, lack of skill, negligence, malicious Acts or human error.
- Collapse, impact etc.
- Act of terrorism etc.

The policy can be extended to cover third party liability and other exposures as a result of execution of the project.

Sum insured is required by the policy to be equal to the estimated completely erected value of the contract works inclusive of materials, wages, construction costs, freight, customs duties and items supplied by the principal.

If, in the event of a loss it is found that the sum insured is less than the amount required to be insured (which is likely to occur as a result of increase in the cost of materials and wages) the insurers will apply average to the extent of under insurance.

Cover shall commence from the commencement of work or after unloading of the property insured at the site, whichever is earlier. The cover expires when the completed part thereof is taken over or put into service or the date specified in the policy, whichever is earlier.

1.2 Erection All Risks (EAR) Insurance Policy

Contractors All Risk Policy is concerned with contracts involving civil engineering works such as construction of buildings, bridges etc., the Erection All Risks Policy (EAR) also known as Storage-cum-Erection (SCE) policy is concerned with erection/installation of plant, machinery and equipment and structures involving no or very little civil engineering work.

The coverage is the same as under C.A.R. Policy except that testing & commissioning of machinery is covered in this policy. Third party liability cover may be added.

The sum insured shall be the completely erected value of the property inclusive of freight etc., and the costs of erection. Average is applied if there is under insurance and insured has to declare changes in the sum insured due to market fluctuations in wages or prices.

The insurance shall commence, only from the time after unloading of the property specified in the schedule from any conveyance at the site specified in the schedule and shall continue until immediately after the first test operation or test loading is concluded (whichever is earlier) but in no case beyond four weeks from the day on which, after completion of erection a trial running is made and / or readiness for work is declared by the erectors / contractors, whichever is earlier.

Test Yourself 1

Question 1

Which insurance relates to the installation of plant or machinery?

A. Computer Insurance
B. Erection All Risks
C. Machinery Breakdown
D. Electronic Equipment Insurance

1.3 Marine-Cum-Erection (MCE) Policy

Cover under a standard EAR Policy commences with the delivery of the first consignment of plant and machinery at the site of erection. This would require a separate Marine Transit Policy for imported equipments and inland transit policy for indigenous equipment, both upto the project site. Under a composite Marine-cum-Erection policy cover starts from the moment the equipment/s leaves the manufacturers warehouse within the country or overseas and continues during the voyage to the port of entry, unloading at the port of entry, inland transit to the site of erection including incidental storage and thereafter during erection, testing and commissioning.

The Marine cover is against all risks of physical loss or damage as provided by the marine policy with the Institute Cargo Clauses "A" (All Risks). War, strikes, riot and civil commotion are additional perils which can be covered.

1.4 Advance Loss of Profits (ALOP) Policy

This is also known as Delay in Startup Policy (D.S.U.). The policy covers financial consequences of a project being delayed because of accidental damage to the project materials. It follows in principle the characteristics of an annual Consequential Loss Insurance (MLOP) policy, but is issued in advance of the actual commencement of business.

The subject matter of insurance can be profits, standing charges, debt service charges.

The object of an ALOP Insurance is to indemnify the principal or the project owner for the actual loss sustained due to delay in commencement of commercial operations of a new project under installation / construction. This delay must be caused by direct physical loss or damage admissible under the Material Damage section of CAR / EAR insurance covering the contract works.

This is a highly specialised type of policy which is drafted specifically in each case.

1.5 Machinery Breakdown (Also known as Machinery Insurance) Policy

Insurable property under the policy are boilers, electrical, mechanical machinery and equipment. The policy covers unforeseen and sudden physical damage by any cause (subject to excepted risks) to the insured property, in short mechanical and electrical breakdowns, under following situation:

- While it is at work or at rest.
- While being dismantled for cleaning or overhauling.
- During cleaning or overhauling operations.
- When being shifted within the premises.
- During subsequent erection.

Sum insured is the current replacement value and condition of average applies.

1.6 Contractors Plant & Machinery (CPM) Policy

Contractor’s plant and machinery can be insured under CAR / EAR policy as an additional item, if the sum insured under these items is relatively small as compared to the total sum insured of CAR / EAR project. If the sum insured exceeds this figure, an annual policy can be granted to a contractor who may be using his plant and machinery at different projects during the course of the year.

The Standard Contractor's Plant and Machinery policy covers unforeseen and sudden external physical loss or damage from any cause including:

(a) Burglary, theft, riot and strike and malicious damage and terrorism.
(b) Fire and lightning, external explosion, earthquake, flood, inundation, subsidence, landslide and rockslide.
(c) Storm, tempest, hurricane, typhoon and tornado.
(d) Accidental damage while at work due to faulty man handling, dropping or falling, collapse, collision and impact.

The cover is operative whilst the equipment is at work or at rest or being dismantled for cleaning or overhauling or re-assembling thereafter. The cover also applies while the same are lying at contractors own premises. The various locations have to be advised to the insurers.

1.7 Boiler and Pressure Plant Insurance Policy

The policy covers boilers and pressure vessels, against:

(a) damage, other than by fire, to the boilers and / or other pressure plant and to surrounding property of the insured, as specified in the schedule of the policy, and
(b) legal liability of the insured on account of bodily injury, fatal and / or non-fatal, to the person, or damage to the property, of third parties,

caused by explosion or collapse of any boiler and / or pressure plant occurring in the course of ordinary working. The sum insured should be the current replacement value

1.8 Machinery Loss of Profits (MLOP) Insurance Policy

Whereas the Machinery Insurance or the Boiler and Pressure Plant Insurance Policies indemnify an insured against material damage resulting from breakdown and / or explosion / collapse respectively, such damage may also result in business interruption at the Insured's premises.

In the event of breakdown of or accident to a vital part of manufacturing plant the actual damages to the machinery could be small but the loss sustained through inability to manufacture might be heavy. Not only would the manufacturer 1) be unable to make the profit which he had hitherto been making, but 2) there would also be several continuing expenses to meet although the business was no longer earning the money to pay them. Such continuing expenses are referred to as "Standing Charges". In addition, an effort to reduce the degree of interruption of the business the manufacturer may adopt alternative measures, but at increased costs.

These losses are covered under Machinery Loss of Profits Policy (MLOP). It is a condition of the MLOP policy that a claim must first be admitted under the concurrent material damage policy (i.e. Machinery and / or boiler policy) before a claim becomes admissible under the Machinery LOP policy.

1.9 Deterioration of Stock (DOS) Insurance Policy

The policy known as Deterioration of Stock Insurance or Stock spoilage insurance is a form of consequential loss cover granted in the Engineering Department for stocks contained in large cold stores. The cover is against the risk of deterioration / putrefaction and contamination following breakdown of the refrigeration plant and machinery, a claim for which is admissible in terms of the concurrent Machinery Breakdown Policy.

It is customary to have two different forms of policy, - one in respect of stocks of fish, prawns, frog legs and other types of sea foods, fruits, cheese, provisions and other Dairy products, etc., the other form of policy is exclusively meant for the contents of Potato Cold Storage. Although basic cover is the same in both cases two different forms of insurance protection are provided.

1.10 Electronic Equipment Insurance (EEI) Policy

Electronic equipment, in particular, computer installations with all the peripherals often involve a large number of high valued equipment contained in a relatively small area. An accident such as impact from falling object, leakage of water or steam into the equipment or damage from other extraneous causes may result in very expensive losses.

Some examples of electronic equipment are:

- Electronic data processing (EDP) equipments.
- Electro-medical equipment.
- Telecommunication and navigational equipment.
- Signal and transmitting units etc, etc.

The policy is available to the owner, lessor or hirer, depending upon the responsibility or liability in each case. The policy is divided into 3 sections

Equipment (Section 1)

The cover applies to any unforeseen and sudden physical loss or damage from any causes, (other than those specifically excluded), in a manner necessitating repair or replacement.

The cover available under the material damage Section 1 is virtually on 'all risks' basis i.e., loss or damage from any accidental cause whilst located at the specified premises. The cover includes electrical and mechanical breakdown of the insured items (except loss or damage for which makers are responsible under their contract), impact, damage caused by water, malicious damage and also carelessness, theft and burglary. In addition the policy covers fire and other allied perils like lightning, riot and strike, storm, tempest, flood, subsidence, landslide, earthquake, etc.

Sum insured should represent the current new replacement value of the insured equipment, including all installation costs, and customs dues. Condition of average applies.

A maintenance contract with the computer makers is warranted in the policy.

External Data Media (Section 2)

The coverage applies if the external data media specified in the schedule (type and quantity) inclusive of the information stored, which can be directly processed in EDP systems, suffers material damage by a peril covered under Section 1 of the policy. The coverage applies while the insured data media are kept on the premises.

The sum insured shall be the amount required for replacing lost or damaged data media by new material and for reproducing lost information.

Increased Cost of Working (Section 3)

This section indemnifies the insured for all additional costs incurred to ensure continued data processing on substitute equipment if such costs are incurred as an unavoidable consequence of loss or damage indemnifiable under material damage section of the policy. The indemnity period commences with the putting into use of the substitute equipments may be up to 12 weeks, 26, 40 or 52 weeks.

The ‘excess’ is specified in terms of days as agreed e.g. 4 days (96 hours), 7 days (168 hours).

Test Yourself 2

Question 2

Erection All Risks (EAR) Policy also known as _____________

A. Storage-cum-Erection Policy
B. P.R. costs involved in “disaster management"
C. Cover for “Failure to Perform”
D. Transportation of the defective products

2. Understand other insurance covers available under various categories

[Learning Outcome b]

2.1 Burglary Insurance

Burglary insurance is a major business in the miscellaneous class of insurance. The policy is available to commercial establishments, factories, godowns, shops etc.

Property in any form, including cash, in the business premises can be covered. The risks covered are:

a) Theft of property after actual forcible and violent entry into the premises or theft following actual, forcible and violent exit from the premises.
b) Damage to insured property or premises by burglars

Cash cover operates only when the cash is secured in a safe and is granted only if the safe is burglar proof and is of an approved make and design. The cover is granted subject to the following two clauses:-

(i) The loss of cash abstracted from the safe following the use of the key to the said safe or any duplicate thereof belonging to the insured is not covered unless such key has been obtained by violence or threats of violence or through means of force. This is generally known as "key clause"

(ii) A complete list of the amounts of cash in safe should be kept secure in some place other than the safe, and the liability of the insurer is limited to the amount actually shown by such records.

Some important exclusions under the policy are:

a) theft by persons lawfully on the premises (larceny or ordinary theft is not covered).
b) loss insurable under fire or plate glass policy.

The policy can be extended to cover riot, strikes and terrorism risks at extra premium.

This policy can be issued on First loss basis. Depending on the number of location and fluctuation in values, Burglary policies can be issued on a declaration basis or floating basis, as per practice similar to Fire insurance.

Rates of premium depend upon the nature of insured property, construction and location of premises, safety measures (e.g. watchmen, burglar alarm) etc.

Apart from the proposal form, a security survey is arranged, especially where valuable property with high values is involved.

2.2 All Risks Insurance Policy

The policy is specially suitable for covering jewellery, valuables, curios, antiques and other works of art, paintings, watches, cameras, and other similar articles. Although these policies are known as all risks insurance policies, there are several exclusions like, loss arising from wear and tear, repairing, breakage of glass of watches, breakage of lens in cameras etc.

The main problem generally met with in granting all risks cover in respect of works of art, paintings, pictures, curios and antiques is the fixing of insurable value. The insurable value in these cases is decided on agreed value basis after obtaining, if required, reports of professional valuers.

Moral hazard is an important consideration and policies are issued to known clients only.

2.3 Baggage Insurance

The policy is intended to cover accompanied baggage (not dealer's stock or traveller's samples) during specified journey, which includes air, sea, rail or road travel undertaken by the insured. The risks covered are burglary, theft or damage by accidental means

The route of the journey is specified in the policy, and the cover is operative only when the insured is travelling by an accepted mode of travel on the specified route. The cover is also operative whilst the insured temporarily resides in any hotel or rest house during the specified journey.

Proposal form should be fully completed as regards description, contents and value of each package. Further, if jewellery, valuables and items listed in the exclusions clause are to be covered, then full description and individual values should be noted.

In view of the high moral hazard, these covers are sparingly granted by the insurers and that too, only to known clients.

2.4 Money Insurance

The property covered under this policy is:

(a) Wages in direct transit from the bank to the insured premises.
(b) Money other than under (a) above, in transit to and from insured premises / bank / post office / any other specified premises.
(c) Money other than under (a) and (b) above, collected by the insured's employees and in transit to the premises or bank.
(d) Any other transit as may be specified.

The risks covered are theft, robbery and accident. On payment of additional premium the policy may be extended to cover dishonesty of persons carrying the cash, riot, strike and terrorism risks, disbursement risk, that is loss during payment of wages to employees, etc.

Claims are processed on the basis of the police report and survey report.

2.5 Fidelity Guarantees Insurance

Briefly fidelity guarantee insurance indemnifies the employers against the financial loss suffered by them due to the specified dishonest acts of their employees.

The risks covered are variously specified by insurers. One wording is as follows:

> "If the insured shall sustain direct pecuniary loss caused by act of FRAUD or DISHONESTY committed by the employee at any time during the period of insurance stated herein… the insurer will indemnify the insured in respect of such loss but not exceeding the sum specified in the policy, provided that such loss shall have occurred in connection with employees' occupation and duties…. during the uninterrupted continuance of employment."

It should be noted that –

(i) the cover granted is against a direct pecuniary loss and not a consequential one;

(ii) the loss should be in respect of moneys or goods of the insured;

(iii) the act should be committed in the course of the duties specified;

(iv) if the employee guaranteed under the policy had left the services of the employer and was re-engaged by him, no liability attaches to the policy, unless the consent of the insurers was obtained;

Period of discovery

Fidelity guarantee policies stipulate time limit for discovery of loss. This is so because the loss can occur over a long period without discovery. Investigation of such losses would be troublesome and recoveries may become legally and practically difficult. The customary time limit provided is that the act or acts insured against should be discovered not later than 12 months after the resignation, dismissal, retirement or death of the employee, or not later than 12 months after the termination of the policy, whichever be the earlier.

Types of Policy

(a) **Individual policy**: This type of policy is used where only one individual is to be guaranteed.

(b) **Collective policy**: Where the entire staff or a number of selected individuals are to be covered, a collective policy is issued.

(c) **Floating policy or floater**: This is an extension of the collective form of contract in which the names and duties of the individuals to be covered are inserted in a schedule, but instead of individual amounts of guarantee, a specified sum of guarantee is “floated” over the whole group.

(d) **Positions policy**: This is similar to a collective policy with the difference that instead of using names, the "position is guaranteed for a specified amount, so that a change in the person holding the position does not affect the cover.

(e) **Blanket policy**: This policy covers the entire staff without showing names or positions. This policy is granted only to large firms of repute.

The rate of premium depends upon the type of occupation, status of the employee, the system of check and supervision.

2.6 Television Insurance

The policy covers television apparatus and antenna against loss of or damage by:
(a) Accidental external means;
(b) Fire, lightning;
(c) Short-circuiting;
(d) Flood and storm;
(e) Bursting and overflowing of water tanks;
(f) Theft;
(g) Riot and strikes; and
(h) Earthquake fire and shock.

The policy indemnifies the insured:
(a) against loss of or damage to the television apparatus;
(b) against all sums which he may become legally liable to pay for accidents caused by or through the television apparatus. (third party liability)
(c) against loss of or damage to the property belonging to or in the custody of the insured, by breakage or collapse of the aerial fittings or mast of the apparatus (so far as such property is not otherwise insured).

The important exclusions are (i) damage to cathode ray tubes, (ii) burning out of valves or coils, and (iii) theft of parts, unless the apparatus is also stolen at the same time.

2.7 Pedal Cycle Insurance

This policy covers loss of or damage to the cycle by fire, lightning, explosion, burglary, housebreaking, theft and accidental external means. It also covers the insured's legal liability for bodily injury to third parties and for the loss of or damage to the property of third parties. The policy may be extended to cover personal accident insurance benefits on payment of additional premium.

Loss of or damage to rubber tyres, lamps, tools and accessories is covered only if they are lost or damaged in the same accident in which the insured pedal cycle is also damaged. Theft of these parts is covered only if the cycle is also stolen at the same time. Wear and tear, mechanical breakdown, war, riot, strikes, earthquake, overloading and use of the cycle for business, profession, racing, pace-making, speed tests, etc. are excluded. Usually, a small excess is imposed in the 'loss or damage' section of the policy.

2.8 Plate Glass Insurance

This policy provides cover against the actual breakage of plain glass of ordinary glazing quality completely and securely fixed, by any reason whatsoever except those that are specifically excluded. Normally breakage due to fire, explosion, gas, heat, earthquake, flood, war, riot and strikes, is excluded. Breakage due to some of these may be covered on payment of additional premium.

The rate of premium depends on the type of glass, situation, neighbourhood and past claims experience.

The following points may be noted:

(a) Only actual breakage is covered. For this purpose, there has to be a fracture of the glass through its entire thickness. Superficial damage like scratching or disfiguration is not covered.

(b) Only plain glass of ordinary glazing quality is covered. If embossed, silvered or ornamental glass is to be covered, additional premium is required to be paid.

2.9 Neon Sign Insurance

This insurance provides cover in respect of loss of or damage to the neon sign installation by (a) accidental external means or (b) fire, lightning, external explosion or theft.

Some exclusions are:

(a) The fusing or burning out of any bulbs and / or tubes arising from short-circuiting or arcing or any other mechanical or electrical defect or breakdown;

(b) Repair, cleaning, removal or erections, wear and tear, depreciation or deterioration;
(c) Damage to tubes unless the glass is fractured;
(d) Over-running, over-heating or strain;
(e) Atmospheric conditions;
(f) Strikes, riot, civil commotion. (Riot and strikes may be covered on payment of additional premium);
(g) Natural calamities;

(Note: Hoardings may also be covered, more or less, along the same lines as Neon Sign Policy).

2.10 Householders Insurance

This is a package insurance scheme designed to meet the requirements of a householder by combining under a single policy a number of contingencies which are otherwise covered under separate policies. The policy is comprised of 10 sections.

Section (1): Loss of or damage to the building and contents (excluding money and valuables) whilst contained in the insured premises by Fire and allied perils.

Section (2): Loss of or damage to contents (excluding money and valuables) whilst contained in the insured premises by Burglary, House breaking including larceny and theft.

Section (3): Loss of or damage to Jewellery and valuables caused by accident or misfortune whilst anywhere in India.

Section (4): Loss of or damage to fixed plate glass by accidental means.

Section (5): Unforeseen and sudden physical damage caused by mechanical or electrical breakdowns of domestic electrical, electronic or mechanical appliances specified in the policy and whilst contained in the insured premises.

Section (6): Loss or or damage to Television apparatus including VCR/VCP whilst contained in insured premises.

Section (7): Loss of or damage to Pedal Cycle(s) and legal liability to third parties.

Section (8): Loss of or damage to personal baggage due to accident or misfortune whilst travelling anywhere in India.

Section (9): Personal Accident Insurance for insured, his spouse and children as per Personal Accident Insurance practice.

Section (10) (A) Legal liability of the insured in respect of accidental death or bodily injury to third party through fault or negligence of insured / family members.

(B) Legal liability as per W.C. Act / Common law towards employees.

2.11 Shopkeeper's Insurance

The policy is designed for small shopkeepers, that is, whose property is valued at less than Rs.10 lacs. The policy is comprised of 11 sections.

Section 1: Loss or damage to (A) building / (B) contents (excluding money and valuables) whilst contained in insured premises by Fire and allied perils,

Section 2: Loss of or damage to contents (excluding money and valuables) whilst contained in the premises by burglary and housebreaking. (No theft risk is covered)

Section 3: a) Loss of money in transit due to accident/misfortune.

b) Loss of or damage to money/valuables by Burglary/housebreadingwhilst contained in a burglar proof safe.

c) Loss of money whilst lying in cashier's till and or counter in insured's premises by Burglary, house-breaking or following assault/violence on insured or his employees.

Section 4: Loss of or damage to pedal cycle (s) and legal liability to third parties.

Section 5: Loss of or damage to fixed plate glass in the insured premises.

Section 6: Loss of or damage to Neon Sign/glow sign by

Section 7: Loss of or damage to Personal Baggage of insured or baggage in connection with trade, any where in India.

Section 8: Personal Accident cover for insured/his employees as per P.A. practice.

Section 9: Direct pecuniary loss suffered by the insured due to fraud or dishonesty committed by any salaried employees.

Section 10: A) Legal liability in respect of accidental death or bodily injury to a third party or accidental damage to their property during performance of any act in connection with the insured's business.

B) Liability to employees under the W.C. Act/common law.

Section 11: Business interruption due to operation of perils covered under Section 1 and subject to claim payable thereunder.

Common Features of Householders and Shopkeepers insurances

Under both the above policies, cover under fire section is compulsory. The insured can choose any of the remaining covers.

The premium depends upon the sum insured, the type and number of sections covered. The coverage, exceptions, etc of various policies when taken separately, apply to the corresponding sections of these policies.

2.12 Banker's Blanket Policies

Bankers' Indemnity Insurance is a combination of several specific covers, such as fire, burglary, money-in-transit, fidelity guarantee and even Marine (inland transit). The policy provides indemnity for direct loss of money and / or securities sustained by the insured and discovered during the period specified in the policy.

The term 'money' is deemed to mean bank notes (signed and unsigned), coins, jewellery, ornaments pledged with the insured, etc. The term 'securities' is deemed to mean, air consignment notes, bank money orders, bills of exchange, bills of lading, certificates of deposit, certificates of shares / stocks, etc.

Some important exclusions are:

- Trading losses, whether or not within the knowledge of the insured notwithstanding any act or omission on the part of the employee whether within the scope of authority or not.
- Losses attributable to faulty computer programming or fraudulent use of computer programme or any other EDP System.
- Losses caused by negligent act or omission of the insured employees. It may however be noted that under Section B – Transit cover, losses due to negligence of employees is covered.

(Note: An ‘excess’ applies to each loss except that caused by fire, riot & burglary)

The proposer has to select the sum insured which is the limit of liability of the insurer for any one loss. The premium is based on the following:

(a) The limit of indemnity i.e. Basic Sum Insured.
(b) The total number of persons employed by the Bank

Claims assessment is generally entrusted to surveyor with Chartered Accountancy qualifications.

2.13 Jeweller’s Block Policies

In recent years India has become a leading centre in the world trade of jewellery and is a major exporter of processed gold jewellery and precious stones. Jewellers Block Policy is a package scheme covering several types of losses. Jewellery, gold and silver ornaments or plate, pearls and precious stones, cash and currency notes and / or merchandise and materials usual to the conduct of the insured’s business, is covered.

The cover provided under the policy is divided into four sections. It is not necessary for the proposer to cover the risk under all the 4 sections. If a proposer desires he can cover the risk under Sections I & IV only. However coverage under Section I is compulsory.

Section I - Loss of or damage to property whilst contained in the premises insured by fire, explosion, lightning, burglary, house-breaking, theft, hold-up, robbery, riot, strikes and malicious damage and terrorism.

Section II - All Risks cover whilst the property insured is in the custody of the insured, his / her partners, his employees, directors, sorters of diamonds OR
Whilst such property (excluding cash or currency notes) is in the custody of persons not in regular employment of the insured such as brokers, agents, cutters and goldsmiths.

Section III - All Risks cover whilst such property is in transit by Registered Parcel Post, Air Freight and through Angadia.

Section IV - Cover for trade and office furniture and fittings in the premises against the risks specified in Section I.

For rating purposes the risks are divided into three categories

Class I - Watchman employed on 24 hours basis (round the clock) specifically by the insured for all the premises.
Class II - Common Watchman for the premises or night watchman for the premises.
Class III - All types of other risks.

Claims assessment is usually handled by Chartered Accountant Surveyors.

2.14 Office Protection Shield (General Office)

The policy offers combination of different covers as follows:

- Building (if owned) – fire and allied perils
- Contents – fire and allied perils, burglary
- Tenant's liability
- Money on premises and in transit
- Fixed glass
- Fidelity guarantee
- Electronic equipment and portable computer
- Rent for alternative accommodation
- Breakdown of office appliances
- Baggage
- Personal accident
- Mediclaim
- Public and Employer's liability

2.15 Crime Insurance

Crime insurance is a relatively new type for the Indian market. It is not a big portfolio but the larger Indian corporates are beginning to understand the importance of Commercial Crime covers.

Subject Matter: Crime cover, being new, tends to be a package-style of cover picking up the more traditional covers of:

a) **Employee Theft Coverage:** Loss of money, securities or other property by theft or forgery by an employee of the insured. This cover was traditionally known as **Fidelity Guarantee.**

b) **Premises Coverage:** Loss of money or securities from the insured's premises by third parties including computer **theft** of money. Traditionally this risk was covered under **Money Insurance.**

c) **Transit Coverage:** Loss of money or securities from outside the insured's premises by a third party, while being transported by the insured, an armoured motor vehicle company or a person authorised by the insured. Traditionally this risk was covered under **Money Insurance**

d) **Depositors' Forgery Coverage:** Losses from instruments, such as cheques fraudulently drawn on the insured's accounts, by a third party.

e) **Computer Fraud Coverage:** An extension to cover losses sustained by the insured due to computer fraud by a third party, including cover for expenses incurred by the insured due to a computer violation.

Classification and Rating: The principal coverage relates to the Employee Theft covers, with the result that the insurer decides rates on the employee wage roll, primarily with an adjustment to the rate, dependent on the extent of the Limit of Liability.

Underwriting: There are certain trades which have a heavy Crime Insurance risk – these would be companies in areas such as the Financial Services Industry, parts of the entertainment industry e.g. Casinos, Jewellery industry, etc. The Underwriter will also be keen to encourage the insured to carry a deductible

2.16 Aviation Insurance

Aviation Sector Insurance Product was first launched in the early years of 20th century and its policies were laid down in the year 1911 by Lloyd's of London.

Following the increased popularity of air travel, the Warsaw convention was signed in 1929 and this has been followed by various other conventions and protocols, such as the Montreal Convention, keeping in mind the concerns of the people flying by air.

Considering the fact that there should be a specialist insurance sector, an aviation committee was formed by the International Union of Marine Insurance (IUMI) in the year 1933. By the following year, International Union of Aviation Insurers (IUAI) was established with eight European aviation insurance organizations resolving to figure out the concept of aviation insurance. Today, there are a number of insurance markets depending on the aviation activity, providing aviation insurance. The largest market is in London with the US also having a major share in the world's general aviation fleet and is an established market in this sector.

Thanks to the many facets of the subject, a number of specific insurances such as the following have evolved over the years:

- Aircraft hull policy - covering loss of aircraft or damage to aircraft
- Aircraft liability policy
- Liability of aircraft owner / operator in respect of accidental bodily injury or property damage
- Liability towards passengers both in respect of accidental bodily injury and also towards loss or damage to baggage and personal belongings of passengers
- Aviation war and allied perils
- Aviation product's liability
- Airport operator's liability
- Aviation service provider's liability
- Aircraft owners / operators

We will look into the details of some of the popular products in this space.

(a) Aviation Hull

The insurance of the aircraft itself is referred to as “Aviation Hull” insurance and covers the aircraft itself against loss or accidental damage. The policy is normally called an "All Risks" policy, although as we have seen earlier, this is a misnomer to a certain extent, as there are a number of exceptions and exclusions restricting the cover. Examples of these exceptions would include:

- Any kind of consequential loss, or loss of use and delay.
- Wear and tear of the aircraft is not to be included in aviation insurance.
- Ingestion damage caused by stones, grit, dust, sand, ice, etc. is excluded.
- War damages are excluded. War here means any kind if civil war, strikes, riots, disturbances, confiscations, hijacking or any kind of political or terrorist attacks.

These policies are also subject to a standard level of deductible, applicable in case of partial loss. This deductible usually relates to the size and type of aircraft. For example, a small plane such as a Twin Otter may have a relatively low deductible of around USD $ 50,000 increasing to USD $ 1 million for a civil airliner, such as a Boeing 747.

Presently the bulk of airline hull "all risks" policies are formed on the basis of agreement between the insurers and the insured; covering for a stated policy period, the value of the aircraft and in any case of total loss, the agreed value should be payable in full. There is no option for replacement under such an agreement.

(b) Aviation Hull War Risks Insurance

The 'War Risks Insurance' is excluded from the basic Aviation Hull cover. However, a separate 'War Risks' cover is available with the major exclusions being:

- detonation of a nuclear weapon
- war between the "Great Powers" – defined as the U.S.A., the Russian Federation, China, France and the U.K.

Other exclusions, that insurers may apply, can include the following:

- confiscation by the "state" of registration (may be insurable at additional cost)
- debt, failure to provide bond or security or any other financial cause under court order or otherwise;
- repossession / attempted repossession of the aircraft
- delay and loss of use

The Aviation Hull "War and Allied Perils" policy is also on an "Agreed Value" basis against physical loss or damage to the aircraft, although the deductibles are not normally applied in respect of losses arising out of "War and Allied Perils".

(c) Aviation Hull Total Loss Only Insurance

'Aviation Hull Total Loss Only' cover has been devised to take care of total loss of an aircraft. This cover is particularly formed for the old aircrafts, as such aircrafts are generally in poor condition and are insured for low amounts and the premium for which would also be very low.

The proportion of partial losses to total losses in case of such an aircraft is very inadequate.

(d) Aviation Liability Insurance

Liability has basically two dimensions – internal and external, although both are normally being covered in a single liability policy:

- Internal - in regard to passengers, baggage, cargo and mail carried on the aircraft. These liabilities result from the operations the airline is set up to perform and are normally the subject of a contract of carriage, like a ticket or airway bill, which may provide some possibility of limiting the airline's liability.

- External – "Aircraft Third Party Liability" which is the legal liability for property damage or injury or death to persons outside the aircraft.

The exceptions under liability insurance are:

- Damage to own property – loss or damage caused to the insured's own property
- War and allied risks associated with it, although the cover can be picked up through a write-back endorsement to the Aviation Liability coverage
- Noise and pollution, unless resulting from the air accident, fire or explosion from within the airplane.

(e) Airline General Third Party Liability Insurance

This refers to the liabilities that might arise from other than the use of aircraft i.e. from the premises, hangar keepers and products liability and are called "Airline General Third Party Liability" and the risk must arise from what are described as "aviation occurrences" i.e.

- involving aircraft
- arising at airport locations
- arising at other locations in connection with the airline's business
- transporting passengers / cargo
- sale of goods / services to those involved in the aviation industry

Many airlines cover their "Airline General Third Party Liability" within their main liability programme and are placed on a Combined (Bodily Injury and Property Damage both together) Single Limit Basis.

Exclusions from liability insurance may include items such as:

1. Damage to the Insured's own property
2. War and Allied Risks, although these can be "written back"
3. Radioactive Contamination
4. Noise and Pollution, unless caused by a crash, fire, explosion or "in flight" emergency

2.17 Satellite Insurance

In 1965, the first satellite insurance was placed with Lloyd's of London to cover physical damages on pre-launch for the "Early Bird" satellite Intelsat I. Satellites are very complex machines, which are manufactured and used by governments and a few larger companies. The budget for a typical satellite project can be in excess of billions of dollars and can run over 5–10 years, including the planning, manufacturing, testing, and launch.

Satellite insurance, therefore, is a very specialised area of aviation insurance. At the beginning of this century, there were around 20 insurers from all over the world, participating directly; while others participated through reinsurance arrangements.

Satellite Insurance covers four principal risks

1. **Pre-launch insurance:** covering loss or damage to satellite or its parts etc. from the time of leaving the manufacturer's premises, during the transit to the launch site, through testing, fuelling and integration with the launcher, up until the launcher's rocket engines are ignited for actual launch.

2. **Launch insurance:** covering the period from the intentional ignition of the engines, until the satellite separates from the final stage of the launch vehicle or until completion of the testing phase in orbit. Typical coverage usually runs for a period of twelve months but is limited to 45–60 days in respect of testing phase in orbit. Launch failure is the greatest probability of satellite loss and approximately 7% of satellites have failed on launch.

3. **Orbit insurance:** covering physical loss, damage, or failure of the satellite while in orbit or during orbit placement. Elements of risk attached to satellites during orbit are damage caused by objects in the space environment, extreme temperatures, and radiation. Since typically it is not possible to repair a satellite, once it is physically placed in orbit, the coverage is basically granted as a product guarantee.

4. **Third party liability** is the final section of the policy, and is a statutory requirement of the Government of the country, where the launch will take place, regardless of the nationality of the satellite owner. A special license must be provided to the regulating authorities, before a launch can take place. Coverage usually runs upto 90 days following the actual launch. Loss of revenue coverage is also available but is rarely purchased.

Ground Risk Liability

As many ground stations are run by large government entities such as NASA, failure on the part of the insured is rare. In cases where failure occurs due to events which are beyond the control of the insured (such as an earthquake), coverage provides for the cost of hiring premises, replacing computer systems, software backup, and other items necessary to resume operations.

2.18 Oil and Energy Risks Insurance

Oil and Energy Risk insurance is also known as off-shore insurance. Off shore risks are to be understood primarily as oil exploration and production units at sea, including the associated pipeline, cables etc. Oil and Natural Gas Corporation (ONGC) and some other companies are engaged in these operations.
A simple outline of offshore operations relating to exploration and production of oil and gas is provided and insurance policies appropriate to each phase of operations are briefly dealt with.

The first step is a seismic survey by geo-technical experts who use specially designed survey vessels for the purpose. The vessels are usually insured by the owners, under a marine hull policy.

The second phase is exploratory drilling. This is done from a floating platform known as MODU (Mobile Off-Shore Drilling Unit) The mobile rigs are of various types, the latest being specially designed drill-ship.

The drilling units and the equipment require insurance for various perils the major ones being:

- Damage / total loss due to blow-out which means an unintended flow from the well of drilling fluid, oil, gas etc. which cannot be stopped.
- Fire
- Weather hazards, storm
- Collision
- War, Strikes etc.

The drill ship and rigs are covered under special clauses known as Standard All Risks Drilling Barge form of Lloyds of London.

When oil and gas is detected by mobile rigs, and it is commercially feasible to develop the oil field the next phase is to set up production facilities. To drill development wells, an off-shore fixed platform is built and raised at a suitable site in the waters. Platform can be of two types – well platforms which may have a number of producing wells or process platforms where the process of separating gas, water and sediments from the crude is undertaken.
This phase involves land fabrication of steel platform towing them to sea on barges and installation by driving steel piles down into the seabed.

1. During construction phase, off-shore platforms are covered under the Builders Risk clause applied to ships under construction. Towing from the building to the installation site is insured under Institute Voyage Clause offered in marine hull insurance. (pipe laying risk can be covered either as part of the overall construction policy or insured separately).
2. Once the contractors complete the installation of a full-fledged platform the operating phase commences. The risk now to be considered, both for well head and process platforms are contact damage by supply boats, fire, heavy weather etc. The coverage is provided under the Standard Platform All Risks Clauses.

Apart from physical damage to the platforms, pipelines etc. there are other hazards involved. As a result of well going out of control, the following expenses are likely to be incurred by the operators.

a) Cost of controlling the blow out
b) Cost of cleaning up
c) Liability to third parties from pollution
d) Cost of re-drilling the well
e) Evacuation expenses

Cover for these costs are provided by the Energy Explosion and Development (EED) clause.
All the policies in the different phases required by the oil company are nowadays combined in a package policy. Insurance is also available on All Risk basis under Oil and Gas well Drilling Floater Form (All Risks) clause to cover on shore oil and gas well drilling equipment at locations and in transit on land within the limit as agreed.

2.19 Cyber Liabilities

Quote: "If I want to steal money, a computer is a much better tool than a handgun. It would take a long time to steal $10 million with a handgun. " -- Daniel Geer, security expert

This is arguably the newest, sizeable, insurance portfolio launched in recent years and has been born from companies becoming aware that they are increasingly at risk from exposures, that originate from their use of technology.

Most forms of insurance either exclude or inadequately cover losses that arise from use of the internet, e-mail or networked systems. As a result, companies that are reliant on these technologies, frequently find that they have inadequate protection, but only discover the deficiency when they need to make a claim. This can come as an expensive shock.

However, at present, it is not well understood with underwriters and reinsurers still looking to build sufficient books of business and information databases to accurately underwrite the differing covers.

The Portfolio: is a combination of covers, some traditional and others new, which an insured may or may not require

It also looks to address:

1. First Party losses including Consequential Losses; and
2. Third Party losses

Examples of these covers can include the following:

(a) Third Party Liabilities

- Allegations that arise from a breach of confidentiality / data protection legislation
- Allegations of libel and slander; for example; due to e-mail, web site or employment advertising content
- Claims that arise from damage to a Third Party's computer systems, such as through an insured forwarding a virus, DOS attack or an employee hacking or committing fraud

- Claims arising from third party consequential loss, through an insured not being able to access their computer systems / website

(b) Professional Indemnity

- Claims arising from negligence, error, breach of contract, breach of privacy (data protection) arising when working with a third party
- Claims arising from perceived failure to conform to a written specification or failing to meet implied statutory terms concerning quality.
- Claims arising from dishonesty of employees or contractors.

(c) Employee Claims

- Claims of an inappropriate workplace, such as sexual or racial harassment charges from an employee due to disturbing e-mail content being circulated
- Claims for breaches of confidentiality due to misuse of sensitive employee information

(d) First Party Losses

- Systems damage – reimbursement for any costs, incurred as a result of attack by a virus, hacker or electronic fraud of an employee
- Business interruption – reimbursement for lost business, if systems are unable to operate due to attack by a virus, hacker or electronic fraud of an employee
- E-theft – reimbursement, if funds are misappropriated electronically
- E-extortion – reimbursement for ransom monies payable as a result of a threat to introduce a virus, hack / damage systems or disseminate information that has been taken from a database
- Intellectual property ‘attack’ – payment of legal costs in pursuit of defending third party infringements
- Brand protection – payment for PR to protect against any negative impact on brand and reputation

2.20 Micro-Insurance

Micro Insurance – IRDA (Micro Insurance) regulations 2005 inter alia state as under:

- A micro insurance product in general insurance would cover Health Insurance, hut, livestock/tools or instruments, any personal accident either on individual or group basis and crop insurance. Life insurance products are available for a maximum period of 15 years.
- The regulations also define a micro insurance product for life business.
- Minimum and maximum sum insured are prescribed in both products.
- A very important feature is that life insurers and the general insurance companies are allowed to have a tie-up to sell each other's products.
- The Non-Government organizations, self-help groups and micro finance, institutions can be appointed by the insurers to sell micro insurance products, as agreed. The normal distribution channels e.g. Agents, corporate agents and brokers can also distribute these products.
- All Insurers have to impart 25 hours of Training.
- All micro-insurance products have to be cleared by the Authority.
- These products are to be delivered in local language to the policy holders.

Test Yourself 3

Question 3

Cyber Liabilities cannot insure which of the following?

A. Losses arising from hacking into the insured's server
B. Liability for the insured spreading a virus to the third party
C. Deliberate malicious lies from the insured to Third Parties
D. Losses because Third Parties could not access the system

Summary

- The Contractors All Risks (CAR) Policy protects the interests of contractors and principals in respect of civil engineering projects, like buildings, bridges, tunnels, etc.
- The Erection All Risks Policy (EAR) policy is concerned with erection/installation of plant, machinery and equipment and structures involving no or very little civil engineering work.
- The Advance Loss of Profits (ALOP) Policy covers financial consequences of a project being delayed because of accidental damage to the project materials.

- The Machinery Breakdown Policy, Contractors Plant & Machinery Policy, Boiler & Pressure Plant Insurance Policy, Electronic Equipment Insurance Policy are the various policies available under Engineering Insurance
- Burglary Insurance protects the insured from theft of property and damage to insured property by burglars.
- Money insurance protects banks, post offices and other specified premises against theft of money in transit.
- Fidelity guarantee insurance indemnifies the employers against the financial loss suffered by them due to the specified dishonest acts of their employees
- Householder's Insurance and Shopkeeper's Insurance protects the respective insured by combining under a single policy a number of contingencies which are otherwise covered under separate policies.
- Aviation insurance products range covers aviation hull, hull war risks insurance, hull total loss only insurance, aviation liability insurance, aviation general liability insurance.
- Satellite insurance covers pre-launch, launch, orbit insurance and third party liability.
- Micro insurance covers life and general insurance products to cover low income group people

Answers to Test Yourself

Answer to TY 1

The correct option is **B**

Erection All Risks relates to the installation of plant or machinery

Answer to TY 2

The correct option is **A**

The Erection All Risks (EAR) Policy is also known as Storage-cum-Erection Policy

Answer to TY 3

The correct option is **C**

Deliberate malicious lies from the insured would not be covered

Self-Examination Questions

Question 1

Earlier employee theft cover used to be known as __________

A. Robbery
B. Embezzlement
C. Fidelity Guarantee
D. Hold Up

Question 2

The first Aviation policies were issued in which year?

A. 1911
B. 1921
C. 1931
D. 1941

Question 3

Satellite Insurance does not cover which of the following?

A. Pre-launch insurance
B. Personal Accident Cover for the Crew
C. Orbit insurance
D. Third party Liability

Answer to Self-Examination Questions

Answer 1

The correct option is **C**

Fidelity Guarantee was the old word for employee theft cover

Answer 2

The correct answer is A

The first Aviation policies were issued in 1911 year by Lloyds

Answer 3

The correct answer is **B**

There is no Personal Accident portfolio within Satellite insurance

CHAPTER 6

UNDERWRITING

Chapter Introduction

This chapter aims to make you understand how the insurer (underwriter) assesses the risk of a proposal and accordingly, how he goes about pricing the risk (if the risk is to be accepted). The chapter will take you through the entire underwriting process step-by-step. The chapter also explains how the insurer can share his risk with other insurers (co-insurance and reinsurance). You will also learn about risk management and the steps involved in it.

Learning Outcomes

a) Understand the concept of underwriting.
b) Examine the underwriting process.
c) Learn about risk sharing.
d) Understand the meaning of risk management and the steps involved.

1. Understand the concept of underwriting [Learning Outcome a]

Underwriting

An insurer has two main areas of income:
1. Underwriting (premium collected), and
2. Investment

In India, the investment returns are much healthy. But with the exception of the PSUs; the other insurers have insufficient critical mass to rely on such returns. This is because Life Insurance Corporation of India (LIC) and the PSU general insurers have been operating for last few decades and have built critical mass, whereas the private insurers are just one decade old.

This leaves underwriting as the main source of income/profit for an insurer. As such, it should be regarded as a central activity and be subject to careful management.

Definition

Underwriting: insurance underwriters evaluate the risk and exposures of potential clients. They first decide whether to accept the risk or not. If the risk is to be accepted, they decide how much coverage the client should receive and how much they should pay for it. Underwriting involves measuring risk exposure and determining the premium that needs to be charged to insure that risk. The function of the underwriter is to acquire - or to "write"- business that will bring money to the insurance company, and also to protect the company's book of business, from risks that they reckon, will make a loss.

Each insurance company has its own set of underwriting guidelines to help the individual underwriters determine whether or not the company should accept a certain risk on offer. For example:

- in underwriting automobile risks, an individual's driving record and type of vehicle are critical
- in underwriting health risks, medical underwriting may be used to examine the applicant's health status (other factors may be considered as well, such as age and occupation).

The underwriters may either decline the risk or may provide a quotation in which the premiums have been suitably loaded or in which, various exclusions have been stipulated, which restrict the circumstances under which a claim could become payable. Depending on the type of insurance product (line of business), insurance companies aim to use automated underwriting systems to encode these rules, and reduce the amount of manual work in processing quotations and policy issuance. This is especially the case for certain simpler life insurance products or personal lines (auto, householders) insurance.

Underwriting is the process of assessing, accepting and pricing risks, applying policy conditions and managing exposures. Although the actual practice and terminology may vary between different classes, the principles are much the same.

The title 'underwriter' is commonly applied to a wide range of people, from a specialist carrying out bespoke liability underwriting for a large multinational, to a junior operative, inputting data into a call centre computer programme for motor insurance.

The underwriter's maxim

1. Maintain a regular review of the existing portfolio rates and terms to ensure that the insurer:
   a. achieves maximum profitability
   b. does not lose quality business
   c. deals appropriately with poor quality business
2. Obtain quality new business at terms which are designed to contribute to profit.
3. Develop new products / product extensions, which can be successfully sold to existing customers, strengthening existing relationships and achieving maximum premium growth from organic growth.

4. Obtain information / feedback from customers, intermediaries and the market in general, to ensure that products, terms, development and profitability are maintained at optimum levels.
5. Identify target segments of the market which will contribute to building of a profitable, quality portfolio.
6. Maintain robust risk inspection / survey programmes for the existing portfolio:
   a. ensuring that the portfolio quality is maintained and policy terms are related to the quality of the risk.
   b. providing risk improvement advice to customers, where applicable.
7. Develop streamlined systems at minimum expense, to achieve the maximum degree of account control and service to customers.
8. Maintain tight control of expenses to ensure that optimum competitiveness and profitability are achieved.

Test Yourself 1

Question 1

Underwriting process involves _____________

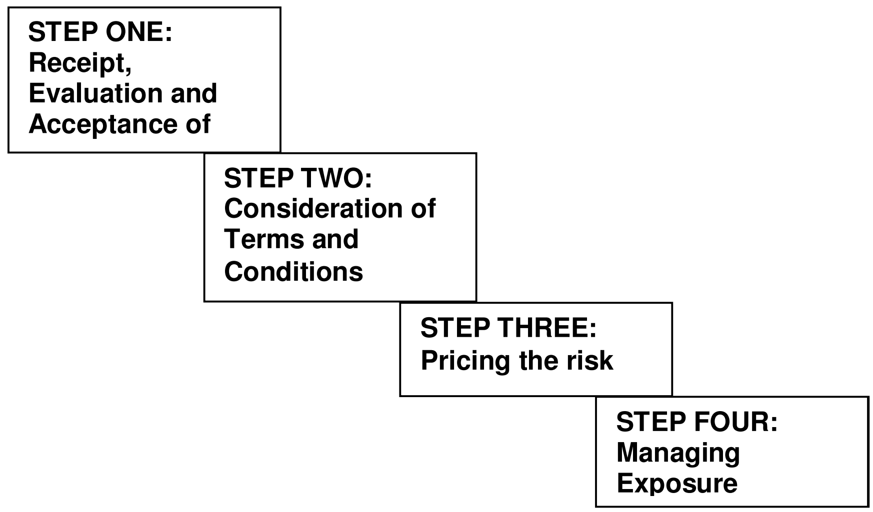
A. Decision on risk acceptance
B. Decision on staff recruitment
C. Decision on investment
D. Decision on employee benefits

2. Examine the underwriting process [Learning Outcome b]

Underwriting process

A standard underwriting process may have the following steps:

Diagram 1: Standard underwriting process



The Underwriting Process

1. Receipt of Risk

Risks may be presented to an underwriter in a variety of ways. Some of these are described below:

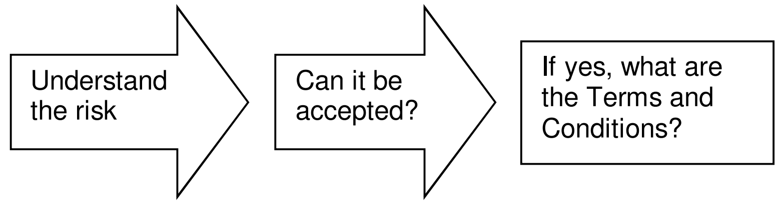
a) a telephone call to operating office or call centre
b) a written proposal form through post from an agent / broker
c) an online proposal through an e-channel (internet)
d) a formal presentation of a large commercial risk by a broker
e) email request from client or broker

The underwriter will acknowledge receipt and at the same time, identify any basic missing information. If the risk is clearly one that the underwriter is unwilling to cover, he will decline the risk at this stage e.g. Motor Insurance on a young driver with a fast car etc.

2. Examine / Evaluate the risk

Once the underwriter gets the risk proposal, he will evaluate it.

Diagram 2: Risk proposal evaluation



The underwriter will have the risk proposal information in a standard format. It will have the following details:

a) Details of the proposer
b) Business, trade and / or activity
c) Cover required
d) Location of the risk
e) Exposure (how big is risk – dependent on type of insurance, sum insured, turnover, wages etc)
f) Claims experience

Beyond this, there will be a considerable amount of information needed that is specific to each class of business and particular risks. Broadly, this falls into three categories relating to:

a. physical hazards
b. moral hazards
c. financial hazards

These hazards can influence the probability and severity of loss.

a. Physical Hazards

Physical hazards are the tangible factors that arise out of the nature of the risk itself. They will come from the features of the property / risk itself, its location, purpose / activity etc.

Example

Motor insurance: model of the car, annual mileage, type of use, driver details etc.
A wealthy client purchases an Audi car for his 18-year-old son on his birthday – In this case, a powerful car and a young and inexperienced driver are a potentially dangerous combination.

Products liability insurance: the proposer's trade, details of goods sold, what their purpose is, markets these are sold into, materials handled and condition of premises are highly relevant.

An engineering components manufacturer reveals that some of its components may be used in aircraft engines. In that case, the catastrophe potential of the failure of these items would merit extremely high premiums.

b. Moral Hazards

Moral hazards are the intangible human aspects of a risk that are much more difficult to ascertain. They include potential to fraudulent claims, carelessness and poor management. There is still an element of truth in the old saying that "you insure people rather than things".

Example

Property Insurance: Piles of waste left in buildings on a long term basis, dirty factory, poorly maintained machinery, etc.
Burglary Insurance: known locally to have poor reputation for fair dealing and casual approach on security aspect.

c. Financial Hazards

Financial hazards are relatively a new consideration with regard to underwriting a policy, although they have been in existence since businesses started operating. Basically, they relate to the financial position of the company – is it in a healthy state, are there cash flow problems, credit risks, etc.

Where a company is in a perilous financial situation, it will eventually be reflected in poor maintenance of machinery, low morale of workforce from pay restraints, deterioration in management control , etc.

3. Collection of information

To assist in the assessment of the risk; the underwriter will need information and this will come from a number of different avenues:

a. **Proposal Form**: The simplest risks (such as Private Motor) may have all the relevant information supplied on the proposal form itself.

b. **Questionnaires**: Certain trades identify specific risks within them that require the use of secondary information. One example could be a Liability Insurance Proposal for a construction company that shows that they are involved in tunnelling – it is not worthwhile including tunnelling questions on all Liability Proposals; so a supplementary questionnaire, relating solely to tunnelling, will be forwarded to the company for filling the required information in such cases.

c. **Surveys:** The initial presentation of the risk may not provide enough information for the underwriter to make an assessment. In a significant proportion of commercial cases, the underwriter will ask for a risk survey. This could be carried out by one of the insurer's own engineers, a broker's surveyor or possibly by an independent specialist. The surveyor will visit the proposer, discuss the risk in some detail and write a report with recommendations to the underwriter. Inspection reports play a major part in the larger and more complex cases in property, business interruption, liability, etc.

d. **Local Knowledge**: It is likely that the client is known within the insurer's office and this can assist in a judgement. For example, if a particular Group's operations are recognised as highly ethical and professional – this will influence the underwriter's judgement positively.

e. **Websites**: Proposer company's website can have useful information on the client and the risks the company is prone to i.e. the website may have details of the processes.

4. Acceptance of risk

Once the underwriter has assessed the risk and is convinced that it satisfies the various criteria in the company's underwriting policy; the risk can be accepted.

The criteria in the company's underwriting policy may include:

- acceptable and non-acceptable types of risk
- geographical limitations
- accumulation hazard
- limits of indemnity

5. Policy Terms and Conditions

Most policies will have standard wordings including definitions, conditions and exceptions and the underwriter will need to ensure that the standard wording is satisfactory for the risk. If not, he will need to specify the changes in wording to restrict or extend the cover and impact on future claims.

The policy wording is a legal document. Policy document is accepted in court of law as a legal document in case of disputes. It is likely that in many areas there will be standardised endorsement wordings that can simply be added to the policy wording.

Example

The insurer may have received representation that no flammable liquids were used in the processing, and on this assurance he has reduced the base rate significantly but has added the following wording – "It is a condition of this policy that there are no flammable liquids with a flashpoint below ___ degrees stored or used on the premises defined in the schedule to this policy"

Other standard forms of policy terms and conditions are given below:

a. Deductible

This is also known as 'excess'. The insured must pay the first part of any claim.

The purpose is twofold:

1. to discourage small claims
2. to give the insured a financial interest in the management of the risk

Example

Large deductibles are common in the professional indemnity insurances for the Indian IT industry, to ensure that the policyholders have a major interest in taking care, that the advice / service given to a client, does not expose the firm to undue risk.

Large commercial insureds may elect to take substantial deductibles by way of self insurance, in order to reduce the premium.

b. Warranty

A warranty requires an insured to do, or not do, certain things and is often linked to a specific trade. A breach would make the policy voidable. Warranties may arise out of the survey report and are intended to deal with a particular hazard e.g. daily removal of waste products. Others may be a matter of common sense e.g. sprinklers to be regularly tested.

c. Exclusion

Most policies carry standard exclusions e.g. War Risks, Nuclear Risks, etc. Some, like the standard Fire policy also carry automatic exclusions (earthquakes, spontaneous combustion, etc) which can, if necessary, be bought back as cover. In addition, the underwriter may wish to apply specific exclusions e.g. the policy will not cover certain buildings owned by the insurer.

6. Pricing

Once the terms have been decided, the underwriter can define the appropriate price for the risk. The initial stage in most classes of insurance will be the "book rate" – a defined figure for a standard risk. This is likely to be detailed in the underwriting manuals or, increasingly, maintained on-line and often automatically raised on input of the classification code.

There is likely to be standardised discounts or loadings for aspects relative to that particular cover e.g. above or below average construction (fire insurance), driving restricted to named drivers (motor insurance), cover restricted to accidents of occupation (personal accident insurance), etc. Also, for the size of any voluntary deductible, long term agreement or size of risk. On top of this, the underwriter may wish to add a further loading or subtract a discount, specific to the client.

7. Managing Exposure

The final part of the underwriting process is to manage the exposure from an individual risk or from a group of individual risks that might build up into a huge loss from a single contingency. For example, the underwriter should avoid taking on too many risks in, say, the same flood-prone area (property insurance).

To assist with this, many of the modern insurers, either have or are looking to develop, pin-code based systems, to ensure that there is no large accumulation of risks in a particular area. However, others still rely on paper records and local knowledge.

Definition

Accumulation: this relates to the potential situation where there are large number of individual risks grouped together in such a way that a single contingency could affect all at the same time.

Example 1: A number of Personal Accident risks, flying in the same aircraft
Example 2: A number of shop units in a single mall, insured by the same insurer

If the insurer recognises a significant exposure of risks, that might impact the bottom line through a single incident but wishes to insure the risk – perhaps because of connectional reasons or does not wish to be seen declining an otherwise acceptable risk – the solution could be reinsurance.

File and Use - Since liberalisation of the insurance market in 2000 – 2001, the IRDA has insisted on a procedure of File and Use for any insurance product – old or new. Within this ruling, the insurer must obtain permission from the regulator to sell any insurance product. From the date the proposed wording is passed to the IRDA, the regulator has 30 days to respond.

The insurer must satisfy the IRDA under a number of headings, including

1. General description of the product including product features
2. Target market
3. Distribution channels
4. General policy provisions
5. Reinsurance
6. Pricing assumptions, premium table and results of financial projections
7. Proposal form, sales literature and insurance contract

Further, it must all be certified by an Appointed Actuary

In addition to this, the IRDA has since developed some Market Standard Wordings (MSW) for Fire, Engineering and Motor – these are minimum wordings and the insurer is not allowed to reduce the cover under these with any additional covers falling within the File and Use agreement.
For more information on the regulation itself see http://www.irdaindia.org/fileusegi.htm

Test Yourself 2

Question 2

An excess is another word for _____________

A. Franchise
B. Warranty
C. Deductible
D. Exclusion

3. Learn about risk sharing

[Learning Outcome c]

Introduction

The concept of insurance works on the sharing of risks. Whilst initially this relates to the insured, the insurers themselves have only a finite source of funds from policy premiums and from this amount, all valid claims need to be settled.

There will be times, therefore, when a risk (or portfolio of risks) is so substantial that a catastrophic loss could wipe out a substantial amount of these premiums and place the insurer in a possible closure position.

Reasons to share risk

There may be a number of individual reasons to reinsure an amount of the portfolio. These reasons have a potential to damage the insurer's financial stability. An insurer must reinsure its risk portfolio:

- To protect the account against large claims
- To avoid undue fluctuations in underwriting results, ensuring a balanced set of results each year without 'peaks and troughs' and comforting the shareholders.
- To look to obtain an international spread of risks.
- To gain access to the intellectual capital of the (specialist) reinsurer.
- To gain access to alternative source of capital.
- To allow the insurer to write more business / access other markets, than its own capital would be able to.

Risk Levels

At a basic level, the insurer has two particular levels to think about. Both the levels need consideration from a "risk to insurer's balance sheet" angle and both require different solutions.

1. At the **risk level,** this could relate to very large limits being insured, involving senior business people or celebrities. This is further accentuated when they are in an accumulation situation i.e. all in the same location at the same time. These may not be big enough to damage the insurer's actual balance sheet but could do serious damage to a particular portfolio or risk group.

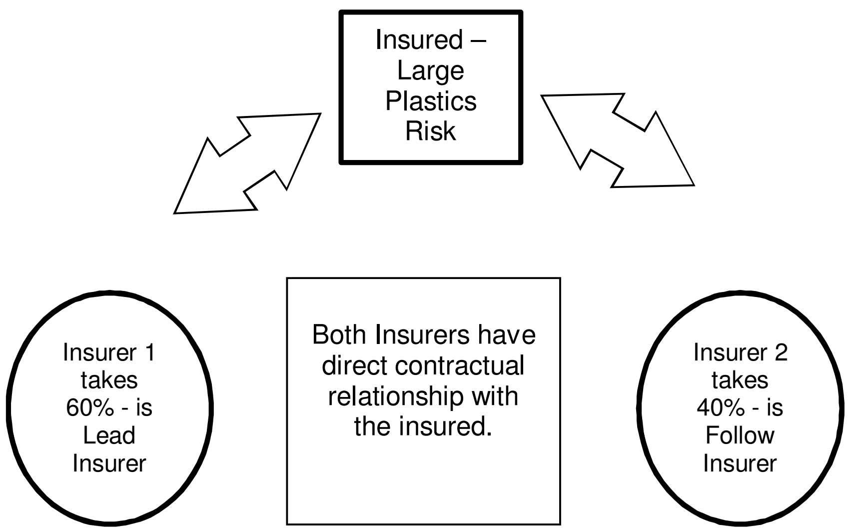
2. At the **portfolio level,** this will relate to all the risks in a particular group – say Group Personal Accident or Hospitalisation covers. In these instances, something like a major natural catastrophe (earthquake) or major pandemic could result in enough claims to damage the insurer's financial stability.

Risk Sharing Methods

These risks were realised by the insurers from a very early stage and when a risk (or risks) was seen to be potentially very large, a share of it was passed to another party in one of two ways – **co-insurance or reinsurance** – who would then receive part of the overall premium.
This remains the situation and the original two methods still hold good today – Coinsurance and Reinsurance

Coinsurance

Diagram 3: Coinsurance



Coinsurance is where a part of the risk is passed to another insurer, **the co-insurer**, usually by way of a fixed percentage share of premiums and claims.

For example: X (the insurer) will connect with Y (the co-insurer) to say that they have a large Personal Accident Risk involving the Board Members of ABC. The insurer X would share 40% of the risk and the premiums with insurer Y – on condition that they take responsibility for 40% of any claim as well, that may arise.

The company offering the risk is called the **Lead** company and will retain an amount not less than the amount that the other company (or companies if multiple sharing) takes. These other companies are called the **Follow** companies and they:

- will be expected to charge the same pricing across the policy
- may give the Lead company a small commission for passing the business to them but frequently this is not done
- will take full responsibility for handling their share of the risk and will have a direct contractual relationship with the insured for their portion of the risk
- will not assist in Treaty Insurance and the risk will always be shared "Proportionately" and not as "Excess of Loss"

Whilst all insurers have a legal contract DIRECTLY with the insured, for the sake of simplicity, it is normal for the Lead Company to issue and service a Policy for the 100% amount and note the Co-insurers' shares by Endorsement.

Test Yourself 3

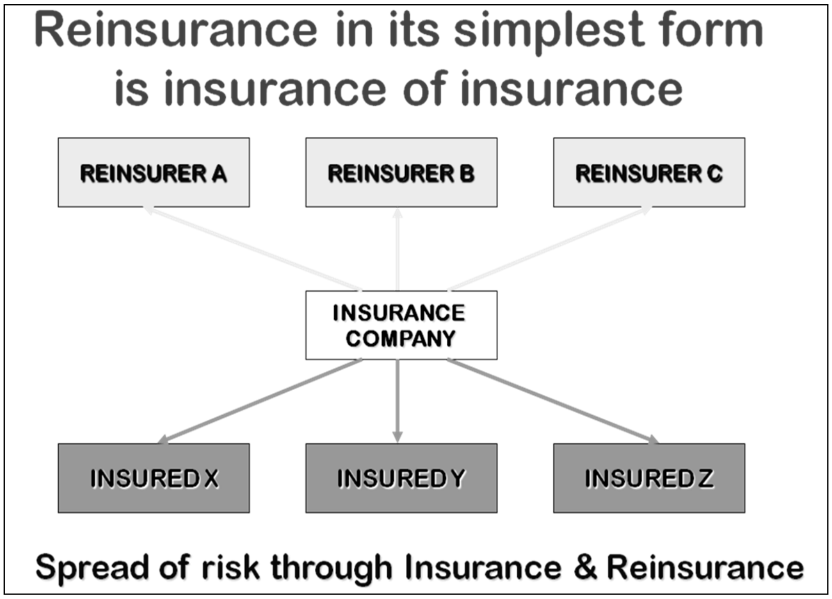
Question 3

Which of the following statements is false?

A. Coinsurance is the sharing of risks between insurers
B. The insurer has a contractual relationship with the reinsurer
C. The re-insurer is the insurer of the insurer
D. The insured has a contractual relationship with the reinsurer

Reinsurance

Diagram 4: Reinsurance



Reinsurance is where an insurer X involves a specialised insurance company - a **Reinsurer** – to assist in sharing the risk**.** The insurer (the **Ceding** Company or **Cedant**) will decide on how much risk they can keep (the **Retention**) and will look to a reinsurer to take the balance risk.

Definition

Contractual Relationship

In coinsurance, both the Lead Company and the Follow Company (or companies) have separate contractual relationships with the insured. In reinsurance, the reinsurer acts as a new insurer, with the primary insurer effectively becoming the policyholder – the contractual relationship is between the insurer and reinsurer. The insured retains the original relationship with the insurer. The particular significance here is that IF the reinsurer is justified in declining the reinsurance responsibility in any claim, then the FULL amount falls on the insurer. The insured does not have any direct relationship with the reinsurer.

Types of reinsurance

In the introduction of this topic we mentioned the two levels i.e. at a **risk level** and at a **portfolio level.** Technically they convert to the two forms of reinsurance

(a) at a risk level – **Facultative;** and
(b) at a portfolio level – **Treaty**

(a) Facultative

Usually it is known by the abbreviation "Fac". It is effectively a "one-off" cover. Individual risks are offered to the reinsurer who quotes on his experience of that particular type of risk.

An example would be, an individual in India, travelling to US for business purpose and wishing to insure his medical expenses for a limit well above what his insurer would normally accept in the market. The limit is substantial and so, is unlikely to be covered by the insurer's **Treaty.** However, the insurer wishes to accommodate this client and therefore, approaches a reinsurer (probably through a reinsurance broker) to accept the portion of the risk above their (the **primary** insurers) retention.

(b) Treaty Reinsurance

This method consists of an agreement between the original insurer and reinsurer whereby the reinsurer automatically accepts a certain liability for all risks falling within the scope of the agreement. This is an obligatory contract in which each party foregoes certain rights –

- the reinsurer may not decline risks falling within the scope of the agreements,
- the insurer must allow all risks coming within the scope to be covered.

Methods of reinsurance

Within the two reinsurance formats, **Facultative** and **Treaty**, there are two main ways of handling a risk, depending on how the primary insurer and the reinsurers, together with any brokers involved see the case – **Proportional** and **Non-Proportional** (or **Excess of Loss**)

Proportional

(I) Quota share

The quota share treaty is an automatic reinsurance whereby the ceding insurer is bound to part with a fixed percentage of every risk written by it. The same percentage is applied to every risk to determine cession in the class of insurance as reinsured – no matter how large or small the sum insured and irrespective of whether the risk is "good" or "bad".

Definition

Lead Underwriter – Reinsurance

We have seen a definition of lead and follow companies relating to co-insurance. There are similar terms that apply in reinsurance. When a broker takes a risk to the market (details are on a note called a "broker slip") he will approach an acknowledged expert in the particular field (a Lead Underwriter). The Lead Underwriter will examine the slip and detail the rate to be charged along with the percentage of the risk he will underwrite. The other underwriters (Follow Underwriters) will then place their respective percentages on the slip, subject to being satisfied with the rate. The broker will move around the market until he has 100% or more (over-subscribed) of the risk covered. Over-subscription is frequently done as there may be an underwriter who later looks to reduce his amount or even withdraw. In any case, 100% risk has to be placed for the arrangement to be complete.

(II) Surplus

An insurer decides that on any given risk or class of risk, he will retain a certain maximum amount, called retention. In reality, he may actually retain a lesser than the said maximum amount, depending on the risk. He will reinsure the surplus to one or more reinsurers. His retention is called one Line. So, he may have an arrangement to reinsure 3 lines with one reinsurer. That will be called a 3 Line Surplus Treaty. If his liability on a certain risk exceeds the total of his retention and the reinsured Lines, then the excess will have to be borne by him.

Alternatively, he can reinsure such excess by way of facultative reinsurance or by way of a 2nd Surplus Treaty, having arranged the same in advance.

An **example**: A ceding insurer's maximum retention may be Rs. 2,000 on Fire insurances covering Flour Mills. On such policies with sums insured of Rs. 2000 and Rs. 3000, the position will be as under:

Sums Insured	Retention	Reinsure
2,000	2,000(100%)	Nil
3,000	2,000(67%)	1,000 (33%)

Non-Proportional Treaty

(I) Excess of Loss (XL)

Excess of Loss or Non-proportional treaties do not protect risk exposure but protect loss as incurred by an insurer. The insurer does not cede risks but seeks protection from a reinsurer against actual losses on each risk as and when they may occur. The reinsurer agrees to pay an amount of the loss over and above (in excess of) a certain amount (called the underlying).

(II) Stop loss

While standard Excess of Loss is related to single loss amounts, either per risk or per event, stop-loss covers are related to the total amount of claims in a year over and above a particular Limit or Loss Ratio.

For example, the insurer agrees to a 70% loss ratio limit and the reinsurer will come in once the insurer's loss ratio hits that figure (Loss ratio = Claims / Premium X 100).
To protect the reinsurer, there will be an upper limit i.e. no further payments from the reinsurer once the loss ratio hits 125%.

FAC

- One risk at a time
- Reinsurer can accept or reject
- Risk underwriting
- Short run (usually a year)

FAC Vs Treaty

TREATY

- Block or class of business
- Usually automatic and immediate
- Reinsurer not involved in risk decisions
- Long term relationship
- Easier to administer

Key Distinctions

Reinsurers – Other Services

Reinsurers can offer expertise and information on:

- Market statistics
- Pricing, underwriting and technical advice
- Policy wordings – in some markets the use of a major reinsurer's wording and pricing can bring instant credibility to an insurers product, but if the reinsurer is supporting a number of other insurers with the same product, it will not give a competitive advantage although still useful as a support to other portfolios.
- IT solutions
- In-depth technical training (underwriting and claims)
- On-going case specific advice
- Market research and performance control
- Claims handling

Test Yourself 4

Question 4

Excess of loss reinsurance is a type of ___________Reinsurance.

A. Proportional
B. Non Proportional
C. Surplus
D. Quota Share

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4. Understand the meaning of risk management and the steps involved

[Learning Outcome d]

Introduction

Underwriting has a strong direct link with risk management

- Good quality risk management will identify areas where the insured can improve the operation in a physical sense – improved construction, firewalls, security etc. - and benefit from a reduced underwriting rate.
- It also reflects high quality of management within the operation and this itself may attract a reduced rate.
- It should also reflect in an improved claims experience in the long term.

Besides this, the insured should benefit from improved working practices and processes. Many of these may not have a direct insurance benefit but will make for a healthier company e.g. improved management of attrition or forex issues.

> **Famous Last Words**: "I have never been in any accident … nor was I ever in any predicament that threatened to end in disaster of any sort." Said in 1907 by Capt. E.J.Smith (Captain of the Titanic)

Definition

Definitions of risk:

1. Risk is the doubt concerning the outcome of a situation.
2. Risk is unpredictability.
3. Risk is uncertainty as to the outcome of a loss.
4. Risk is the chance of a loss.

The management of risk has a number of straightforward steps, which, if followed correctly, will take a client from basic awareness through to completion of a Business Continuity Plan (BCP).

First step is **to identify** – following this we can then move around the risk circle:

Diagram 5: Risk management

1. Risk Identification

Risk identification is all about identifying the business' exposure to uncertainty.

This is best done by a team because each member will see the risk in a different light e.g.

- Legal may see **people** risk in terms of legal suits
- HR may see **people** risk in terms of attrition
- Production may see **people** risk in terms of manual errors
- Finance may see **people** risk in terms of embezzlement

The risk team needs to examine the company intimately both in terms of external and internal exposures, the market in which it operates, the legal, social, political and cultural environment in which it exists and an in-depth knowledge of how it operates.

Methodology

Risk identification should be done in a very methodical manner, using well designed templates, to identify all the basic issues and bring out the more unusual. For example, it may be that the headings of business activities and decisions can be classified in a range of ways, examples of which could include:

Strategic	Operational	Financial	Knowledge Management	Compliance
Long-term strategic objectives of the organisation. They can be affected by such areas as capital availability, sovereign and political risks Legal & regulatory changes Reputation Changes in the physical environment	Day-to-day issues that the organisation is confronted with, as it strives to deliver its strategic objectives Machinery maintenance Fire risk Logistics Crime and security	Management and control of the finances of the organisation and the effects of external factors such as availability of Credit Forex Interest rate movement Other market exposures	Management and control of knowledge resources External factors might include Unauthorised use or abuse of intellectual property, Area power failures Competitive technology Internal factors might be system malfunction or loss of key staff	Health & safety Environmental Trade descriptions Consumer protection Data protection Employment practices Regulatory issues

Whilst many consultants offer their assistance, here in-house ‘ownership’ of the risk management process is essential.

Test Yourself 5

Question 5

The maximum amount that an insurer wishes to keep on any risk is known as what?

A. Capacity
B. Retention
C. Maximum limit
D. Ceding amount

Once the individual risk is identified, it is critical that a clear, concise and correct description is laid down of the particular risk.

This should include:

1. Name of risk e.g. storm
2. Scope of risk – what could happen e.g. ingress of water from floods
3. Result of risk – what's the results e.g. destruction of stock, workers displaced, no visitors
4. Quantification of risk – what is its severity (High, Medium, Low) and its probability (High, Medium, Low)
5. Risk appetite – quantify the financial impact – how much can the organisation take on itself
6. Risk treatment & control mechanisms e.g. insure, remove, accept
7. Potential action for improvement – actions to be taken and by whom e.g.
    a. Flood plain management - Operations
    b. Field drainage - Operations
    c. Protect hi-tech equipment - Operations
    d. Build drainage trenches - Operations
    e. Liaise with local authority - Public relations

This will then form part of the risk register

Definition

Risk register: This is a centrally held hard or soft copy register of all the company's identified risks. They will be a number of entries against each risk under such headings as follows:

1. Title of risk (and where it fits: strategic, operational, people etc.)
2. What are potential effects of risk happening
3. Probability of risk happening
4. Severity of effect if risk happens
5. Who is responsible for risk / owner
6. Solution / counter measures

2. Risk Evaluation

Before a risk can be managed effectively it must be examined carefully, identified and measured in terms of the following factors, so that it may be assessed in comparison with similar risks:

- **Frequency** of its likely occurrence
- **Probability of loss or damage**
- **Severity of the effects of a loss**
- **Perception** of the probability of loss and its effects

There is a relationship between frequency and severity which is important in deciding what action should be taken to handle the risk.

- **Chronic losses** which are small and regular and which are almost inevitable. These should be looked upon as a trade risk. However the annual aggregate total of this type of loss can often be significant and they therefore should not be ignored.
- **Sporadic losses** which are medium sized and irregular that may happen sometime and may be able to be controlled to a significant extent.
- **Catastrophes** which are very large losses which may occur on rare occasions. Such losses will probably have a devastating effect on any organisation that they affect.

3. Risk Management

Basic Components of a Risk Management Process:

•Identification :	The recognition / anticipation of risks that threaten the assets & earnings of a business enterprises,
•Evaluation/ Assessment :	Estimating the likely probability of a risk occurrence & its likely severity,
•Prevention & Control	Measures to avoid occurrence of risk, limit its severity & reduce its consequences,
•Financing	Determining what the cost of risk is likely to be or might be & ensuring that adequate financial resources are available.

Test Yourself 6

Question 6

Which of the following is not a step in risk management?

A. Risk Assessment
B. Risk Evaluation
C. Risk Transfer
D. Risk Pricing

Summary

- Underwriting income and investment income are the two main sources of income for an insurer.
- Insurance underwriters evaluate the risk and exposures of potential clients.
- The underwriting process consists of receipt, evaluation, acceptance of risk, determining policy terms and conditions, pricing and exposure management.

- The insurer cannot maintain everything on his account and needs to examine risk sharing options of coinsurance and reinsurance
- Reinsurance has two types – facultative (one off) and treaty (portfolio management)
- Risk management involves 4 steps: identify, assess, evaluate and mange

Some important terms / definitions you have learnt in this chapter

a) File and use
b) Accumulation
c) Facultative and treaty
d) Risk transfer
e) Severity and probability

Answers to Test Yourself

Answer to TY 1

The correct option is **A**.

Underwriting process involves decision on risk acceptance.

Answer to TY 2

The correct answer is **C**.

An excess is another word for deductible

Answer to TY 3

The correct option is **D**

The insured has a direct relationship with the insurer and no relationship at all with the re-insurer

Answer to TY 4

The correct option is **B**

Excess of loss covers are known as non-proportional type of reinsurance

Answer to TY 5

The correct option is **B**

Retention is the maximum amount an insurer will want to hold

Answer to TY 6

The correct option is **D**

Risk pricing is part of the underwriter's role

Self-Examination Questions

Question 1

The 2 main sources of income for an insurance company are underwriting income and ________ income.

A. Claims Salvage
B. Risk Management
C. Reinsurance Commission
D. Investment

Question 2

Which one of the following is not one of the prime hazards an underwriter looks at?

A. Financial
B. Moral
C. Risk
D. Physical

Question 3

When looking for reinsurance, the underwriter works at two levels – one is at risk level and the other is _______

A. Micro
B. Portfolio
C. Retention
D. Primary

Question 4

_______ covers are related to the total amount of claims in a year over and above a particular limit or loss ratio.

A. Proportionate
B. Stop Loss
C. Surplus
D. Treaty

Question 5

The two ways of measuring risk within a risk register are probability and __________

A. Severity
B. Financial
C. Ownership
D. Transferability

Answer to Self-Examination Questions

Answer to SEQ 1

The correct option is **D**.

The 2 main sources of income for an insurance company are underwriting income and investment income

Answer to SEQ 2

The correct answer is **C**

Financial, physical and moral are the three hazards – risk is the odd one out

Answer to SEQ 3

The correct answer is **B**

When looking for reinsurance, the underwriter works at two levels – one is at risk level and the other is portfolio level

Answer to SEQ 4

The correct answer is **B**

Stop Loss covers are related to the total amount of claims in a year over and above a particular limit or loss ratio.

Answer to SEQ 5

The correct answer is **A**.

The two ways of measuring risk within a risk register are probability and severity

CHAPTER 7

RATING AND PREMIUMS

Chapter Introduction

In the Indian insurance market, it often seems that price is not king but God and this has been clearly demonstrated with the substantial fall in rates following the withdrawal of the All India Fire Tariff.

Fortunately, the Indian market still benefits from reasonable income from its investments, due to decent interest rates. However, it must be clarified that at the moment the cushion of investment income applies only to the Public Sector companies, who have been around for a long time. The private companies have been around for about a decade only and so, are in the process of building reserves. Be that as it may, in the longer term, all insurers must ensure that they generate underwriting profits.

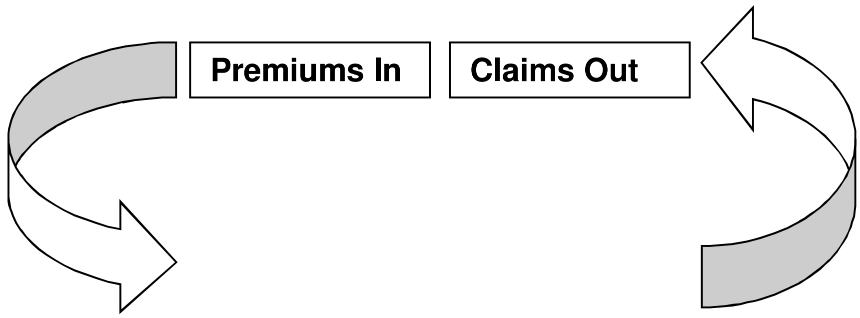
The most important step towards achieving that should be the ability to charge appropriate rates, particularly in a market where previously certain products were highly subsidised e.g. Health, Liability, Accident, etc.

In this chapter, we will look at the basics around pricing and also look at soft and hard insurance markets.

Learning Outcomes

a) Understand the premium pricing mechanism
b) Understand the concept of soft market and hard market

1. Understand the premium pricing mechanism
Learning Outcome [a]



Insurance companies create a pool by collecting premiums from a group of people, who are exposed to the same risk, and pay out claims from the same pool to those who suffer from the risk.

> **Quotation:** An English Act of Parliament in 1601 best sums it up: "The loss lighteth rather easily upon many than heavily upon few."

Pure premium plus expenses

This was the very basic rule that many of the village "co-operative" insurance arrangements worked on – whether it was for livestock deaths or villagers' funerals – everybody donated a small amount knowing that a large amount would be available in the case of a particular contingency.

However, as the markets became more and more sophisticated, other factors came into play. Some of these factors include:

1. Management expenses

These are the ongoing expenses that an insurer will have to incur as he runs the business – they will include headings such as:

(a) Salaries
(b) Travel and Accommodation
(c) Office expenses e.g. rent, telephones, etc.

These can range from relatively low levels in the mid-teens to figures close to 30%.

2. Commissions

This is particularly relevant in the corporate insurance market which, globally, tends to use professional brokers as the main distribution method. Their products are not commoditised and frequently need tailoring or customisation. Obtaining quotes from a single insurer does not make business sense and the insured does not have the time or ability to discuss with all potential markets. Commissions in India for the broking market range upto 17.5%

3. Claims expenses

In addition to paying out the cost of the claims, the claims department also has some expenses in handling the claim – in particular, they could include the use of expert witnesses, qualified surveyors, etc.

These three major expenses, together, constitute a major chunk of the insurer's total expenses. For every Rs. 100 collected, there is likely to be an outgo of upto 35% or so, coming from the above expenses – leaving only 65% for paying claims and a small percentage towards profit.

Test Yourself 1

Question 1

2000 factories require a Sum Insured of Rs.10 crores each. Statistically, we know that 2 factories get destroyed by fire each year. However, we do not know which two !

So, if the losses are to be paid for by all of the 2000 factory owners, what should be the contribution by each factory owner by way of pure premium?

A. Rs. 75,000
B. Rs. 1,00,000
C. Rs. 2,00,000
D. Rs. 3,00,000

So, looking at the test above, we can calculate the "pure" premium, which will then assists us in working out the BOOK Rate.

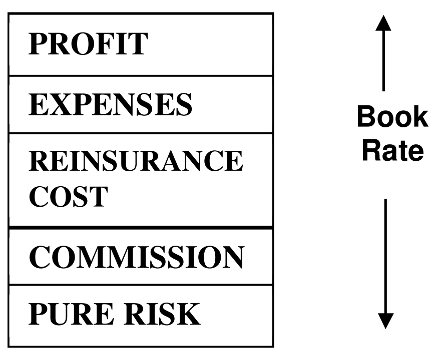
Definition

Pure premium rating method: This approach reflects the expected losses. It is a calculation of the pure cost of, say, property or liability insurance protection. This is without any loading for the insurance company's expenses, premium taxes, contingencies and profit margins. The pure premium is calculated as follows:

$$\textbf{Pure Premium} = \frac{\text{Total Amount of Losses Incurred per Year}}{\text{Number of Units of Exposure}}$$

Book Rate Theory

In theory, a book rate is built up as follows:



The pure risk premium is a quantitative assessment of the liability of the risk.

Technical pricing (the book rate)

This develops from the Pure Premium method mentioned above and goes back to First Principles.
It relies on the insurer having quality statistical information, based on historical loss details and exposure information, collated at market level or intra-company e.g. national fire statistics, weather records, crime statistics etc.

The underwriter can then make comparisons with their experience with similar risks and attempt to model the pattern of potential claims.
If there is likely to be a delay in recording or settling of claims, as there is in the long-tail liability classes, this needs to be considered, along with the investment income that will accrue in the reserves.

Any catastrophe potential will also need to be built in.

From a comparison of the loss experience over a certain period, compared to the exposure at risk over the same period, a technical rate can be identified, which can then be adjusted for expenses, commission, small level of profit, etc.

This will be converted to produce a rate per cent or per mille on sums insured, wage roll or turnover etc. depending on the type of risk and type of policy as also based on the level or rate required for the average risk. Such a rate is called the "Book Rate".

Perhaps the most difficult challenge is modelling future claim patterns, when the business environment is changing.

There is no single right way or wrong way to produce a rate from first principles. However, over the long term, the most successful underwriters have managed consistently to combine good statistical modelling with a flair for anticipating changes in the environment.

Definition

Exposure: in this definition, exposure is the measurement of how big a risk is. For example:

Property Insurance: The Sum Insured on the Building or Contents

Employer's Liability or Workmen's Compensation: The wage roll on a particular trade classification

Products Liability Insurance: Turnover on the relevant product line

Note: The exposure and the benefits may not always be the same e.g. in Products Liability the turnover may be the best form or exposure measurement but the benefit will be based on the Limit of Liability.

Test Yourself 2

Question 2

Which of the following does NOT form a part of "Book" price calculation?

A. Claims Costs
B. Management Expenses
C. Commission
D. Investment income

Trends

As mentioned above, the insurer needs to collate the historical information relating to losses / claims and exposures. However, it is critical that notice is taken of trends – past, present and future – that will affect the assumptions coming from these statistics. This should be done in a structured format and there are a number of areas that need to be considered by the portfolio underwriters. Some of these indicators / trends can be:

1. **Inflation:** In certain classes, the claims costs and the exposures will not be consistent as regards inflationary impact. For example, hotels may be rated on the number of bedrooms as regards the Public Liability Risk – projected claims experience should take into account inflationary changes.

2. **Political:** Changes in the political landscape can change a country or part of a country from high hazard as regards, say, crime risks, to low hazard, over a relatively short period of time (and vice versa). Also, issues such as terrorism have increased significantly over the past 20 years or so.
3. **Technology:** Over the last 2 decades technology has vastly improved safety standards in many industries, by removing much of the manual involvement. For example, printing industry has changed significantly with computerized presses and "just in time" raw materials strategy etc. removing some of the safety hazards and improving the fire risk.
4. **Legal Changes:** in the local legal environment, litigation costs can change significantly. India's litigation costs are now increasing as the wealth of the middle class and awareness of liabilities owed to them, grow steadily.
5. **Attractiveness:** Items such as mobile phones, laptops, etc. can be very attractive for one year and then falling prices and greater availability move them into commodity areas and relatively unattractive mode in comparison.
6. **Others:** may include climatic changes and global warming etc. for example what is the likely effect of global warming on the flood risk?

Example

Piracy was until recently something that was at its peak; however; over the last decade this has changed significantly

Somali Piracy: International Maritime Bureau (IMB) reported on 14 January 2010 a significant increase in worldwide piracy attacks in 2009 compared to 2008 (from 293 to 406). Somalia accounted for half of the attacks in 2009. Somali pirate attacks increased from a total of 111 in 2008 to 217 in 2009. The IMB also reported that there had been a significant shift in 2009 in the location of the attacks, from the Gulf of Aden to areas further away from the Somalia coast in the Indian Ocean. There had been, however, a decrease in successful attacks. In 2009 there were 47 hijackings off the coast of Somalia compared with 42 in 2008.

At one time,Somali pirates were holding more than ten vessels. To date, ransoms paid to pirates operating off the coast of Somalia have been minimally estimated at $30 to $50 million whereas other estimates are considerably higher.

(Courtesy Security Council report April 2010)

Classification

To assist in getting the best possible technical pricing, the insurer must have high quality data collection. This will ensure that the best risks are called upon to pay the cheapest premiums and the worst risks are charged the most.

For each class of business and sub-class within, appropriate management information must be collected and maintained, including:

- Classification and coding of risks to a detailed level
- Factors which could influence claims frequency and / or severity
- Premium data
- Claims data
- Exposure measurement

During the nationalisation period, with the same market agreements and tariffs used across the market, there was limited / no computerization, resulting in collection of statistics being by manual reporting which was inadequate in many instances. It also meant the coding was unsophisticated and outdated.
However, the Indian insurers appreciate the value in building information databases and the modern software programmes as available; mean the collection of such information is much easier.

Many are looking to introduce coding systems, similar to those provided by the International Labour Organisation (ILO) which have developed a consistency globally – India's National Industrial Classification is very similar to the US Standard Industrial Classification (SIC) and the UK SIC and Australia / New Zealand's ANZSIC

SIC codes

This system classifies the Trade Codes in a 5 digit number. An example using manufacturing at its highest, and getting down to a single occupation, may demonstrate this best:

Section 'D'	Manufacturing
Division 17	Manufacture of textiles
Group 171	Spinning, weaving and finishing of textiles
Class 1711	Preparation and spinning of textile fibres
Sub-Class 17111	Preparation and spinning of cotton fibre including blended cotton

Refinements

Once the Trade Classification has been collected, it is important that the insurer collects the sub-data around the particular item and, where possible, assigns codes.

Where possible, these should be codified, although there will be times when a risk attracts a loading or discount, that is unclassified.

Example

Property (Fire) – Construction (above / below norm), Fire Extinguishment, Deductible
Property (Burglary) – Occupancy (someone permanently on premises), Deductible
Motor – Restriction in Drivers, Deductible

All of these can be collected and used to refine rates as tightly as possible.

Some International Motor Insurance Companies boast that they can obtain and interpret Management Information (MI) so fast that they can change rates on a daily basis if need be.

Test Yourself 3

Question 3

When we look at claims trends, we look at a number of factors. Some of these are listed below. Which factor is not to be considered from this list?

A. Inflation
B. Technology
C. Legal Changes
D. Exposures

Burning Cost

This method is much easier than going back to first principles.

Basically, the underwriter:

- identifies, say, the last five years' claims experience
- divides that by 5, to get the average
- adjusts it for any special circumstances e.g. inflation
- identifies the total exposure for the equivalent
- divides by 5, to get the average
- divide the average claims by the average exposure

Adjustments should be made:

1. in turnover and / or wage figures and the loss experience for acquisitions or disposals, that are or are no longer a feature of the risk going forward.
2. Changes in Limit of Liability if it impacted on Claims
3. Claims that may have been excluded in certain years (underwriting decision by endorsement) but paid in others

This 'burning cost' is then translated into a rate by adding allowances for expenses, commission, claims inflation, profit, etc.

This is essentially retrospective rating and considerable care is needed if it is to be used as a guide for future performance (it has been compared to steering a ship by looking at the wave).

It is, however, an acceptable pricing mechanism for some types of reinsurance, where the previous year is being priced in arrears. Less reliable is its use for rating in individual cases, particularly in liability.

This approach clearly works against the law of large numbers, so any results need to be checked against other methods.

The example given relates to Liability Insurance but it can be used in other classes as well and, in larger cases, used as a marker to check whether the technical rate is providing the correct risk premium.

When to use the burning cost method

There are circumstances where the technical guide rate may not be appropriate as the sole method of premium calculation.

For example, where:

- the risk is a diversified industrial or conglomerate one
- where the claims experience produces an inconsistent result over a minimum of 5 years (excluding current year)

Information necessary to complete a burning cost calculation

The information necessary to complete a burning cost rating calculation is:

- Claims experience split between claims paid and claims outstanding
- Turnover or wages
- Previous insurer(s) for each of the past five years,

Adjustments

Adjustments should be made in turnover and / or wage figures and the loss experience for acquisitions or disposals that are or are no longer a feature of the risk going forward.

Reasons for a rapidly improving or deteriorating loss experience

These need to be identified and reflected in the rating decision. For example, it may be that the insured has instituted a risk improvement programme, which is producing results that can be sustained and relied upon (see below).

Large Losses

Although the claims experience is an accurate reflection of how a risk has performed, there may be circumstances where a claim is disproportionately high, compared with the general claims experience, the inclusion of which would distort the overall burning cost picture.

Claims of this type need to be judged on their own merits, to decide whether they are truly exceptional events and are therefore, to be discounted from the calculation, or to be retained and smoothened at a certain level, in order to reflect more accurately the future loss potential.

In either case, there needs to be a supporting rationale, clearly indicated in the workings on file. Before any claim is discounted, careful attention should be paid to the catastrophe potential of the risk i.e. the likelihood of such losses recurring. Where there is no history of such losses, the potential needs to be assessed and taken into consideration as necessary.

Other Claims Issues – Accuracy and reliability of outstanding claims reserves

At any time, the greater part of the loss experience is likely to be in the form of unpaid claims. For new enquiries, it is useful to take note of the information submitted at the previous renewal. As well as providing an indication of the previous insurer's reserving procedure, it also gives a more accurate picture of claims development and changes in the number & size of claim, bearing in mind the standard estimates and changes in the notification procedure. Improving / deteriorating claims experience may be due to changes in the type of work undertaken.

Risk Improvement

a) Date and details of any Liability surveys, including those (or their equivalent) by other insurers.

b) Any subsequent change in claims frequency.

Changes in Cover

Where the insured wishes to take out additional coverage, this increases the potential exposure and unless accounted for specifically in the past experience, will not be reflected in the burning cost calculation.

For **example**, addition of financial loss cover
Increases to the limit of indemnity also require specific underwriting and an additional premium loading may be applied.

Inflation

a) accuracy of estimates for wage roll / turnover

b) where there have been large fluctuations - increases or decreases in wages/turnovers, the burning cost rate may be unreliable and where appropriate, these variations can be smoothed .

c) whether additional turnover has been caused by:

   i. increased output
   ii. fluctuations in the price of raw materials, without a comparable increase in output
   iii. mergers or takeovers
   iv. turnover figures for financial services or commodity companies getting influenced by market conditions i.e. large increases/decreases in trading prices may not necessarily be linked to exposure.

Legislation

Has the trade concerned been affected by legislation during the period under review e.g. relaxation in products safety law may increase the likelihood of claims; changes in environmental law may have an impact on the premises risk.

Rate on Line

This rating method should be used to reflect the price per million, in local currency unit, applied to the limit of indemnity, or to reflect premium needed for a period of years to cover the cost of the limit(s) provided. It is primarily used for accounts, which reveal characteristics of high severity / low frequency potential and risks with high limits of indemnity.

It is inappropriate for smaller risks, as it takes no account of exposure.

Example

A percentage, derived by dividing the premium by the limit

For **example**, a Rs. 100 crores catastrophe cover with a premium of Rs. 2 crores would have a rate on line of 2%.

Test Yourself 4

Question 4

If the total premium is Rs. 50,000 and the Limit of Liability is Rs. 20,000,000; what is the rate on line?

A. 2.5%
B. 0.25%
C. 4%
D. 0.4%

2. Understand the concept of soft market and hard market
Learning Outcome [b]

Hard and soft markets are a part of the "insurance market cycle". They are a function of supply and demand.

Soft Market

In a "soft market", insurance companies (the underwriters) are eager to write new business and to hold onto existing business; and are likely to offer coverage improvements and / or reduced premiums.

A soft market starts when

- Capacity is available
- Insurers' results have improved
- Insurers have achieved their profit goals

The insurers know that if they can

1. write more volume; and
2. maintain their expenses at more or less constant levels; and
3. anticipate cost increases (inflation, actual cost of claims and claims adjustment costs);

they should be able to make a higher return, if they can "simply" add more written premium to the equation.

In theory, the change from hard to soft markets happens in a controlled fashion and some insurers can be extremely successful at the outset.

However, every time a "soft market" begins, all the insurers believe that they will not make the same mistakes or make bad decisions as they did in the past.

Problems: They occur when this phenomenon takes its own direction and more and more insurers feel the same pressure at the same time to increase volumes.

This is because there is one constant out there – even with an expanding economy, the amount of risks and the number of prospects is generally finite and so also the amount of written premium to be tapped is finite.

What happens then is that the pricing gets lower and companies do not make enough net income, thereby increasing the combined ratios to an unacceptable level.

Some insurers start to get concerned that if they do not cut prices even more, they will lose market share. The spiral continues until there is no more room to cut prices and the "hard market" starts.

There is usually a severe catastrophe connected with the end of this market, acting as a catalyst or "the last straw" to make the change.

Hard Market

In a "hard market", insurance companies will often increase premiums and take back some of the coverage enhancements, they provided during the soft market.

Once the underwriter has realised that "enough is enough", the hard market usually intensifies immediately. There may be a very short period of testing the impact of rate increase, before most insurers implement a philosophy of pricing risks at "what the market will bear."

Hard markets tend to come mainly due to two reasons:

1. A capacity issue

Results can be so bad that companies have to shed accounts, because they do not have the Policyholders' Surplus to support the writing of any more business. This can be a really bad situation for certain insureds, especially those with poor exposures, since these are the accounts that are cancelled first.

2. An underwriting issue

There is a significant portfolio review and accounts that do not have good loss ratios are cancelled or have significant price increases, while profitable accounts receive "healthy" price increases. There is likely to be no surplus problem, so that carriers can write as much business as they want but are extremely selective in what they write. The theory here is that the hard market will make the insurers profitable again. It then continues into a desire to write more premiums when insurers are profitable, before shifting to a "soft market" and the cycle continues.

Catastrophe

One element that is rarely included and needs special mention relating to all the above pricing methods is to include an amount for Catastrophe Funding. This is always difficult as it is unlikely to have appeared in any of the claims experience figures (and if it has, it is too large to build into the rating itself). However it is a fact of life that sooner or later there is going to be a significant catastrophe and the portfolios should reserve for such an event.

Commercial Pricing

All the above notes relate to some form of getting the right price for the risk. However, despite getting the right price for the risk, there will be times when an argument is put forward for reducing the premium below the technical, burning cost or book rate.

For example, it might happen to gain an entry into a serious block of business and the insurer needs to have a "loss leader" or it might be to retain a large piece of business, where, otherwise, the loss of it would have implications on critical mass of the portfolio and / or the insurer's reputation.

In these instances, management may be willing to give an additional "commercial" discount – it has no underwriting logic but does have business logic. However, such authority must be given with care. Experience has shown that once commercial discounts begin to be given freely, they become devalued and result in significant under-pricing of the account.

Operational Premium Issues

Rating the Policy

Having built our technical rate we can now apply it in an operational environment. We will build underwriting manuals with sections on the primary rating base. Examples of these are likely to be as follows:

Insurance	**Exposure**	**Classification coding**	**Additional rating / underwriting features**
Fire Insurance	Rate % or per mille on Buildings / Contents Sum Insured (often on reinstatement basis ex-stock)	The individual risks will be divided by trade and ideally by sub-process	Construction, Fire Extinguishers, Undivided Floor Space, Deductible, etc.
Business Interruption	Rate % or per mille on Gross Profit Sum Insured (often on reinstatement basis)	The individual risks will be divided by trade	In addition to those following the fire rate, we will have adjustments for indemnity period

Burglary	Rate % or per mille on Contents Sum Insured	The individual risks will be divided by trade	Security i.e. Burglar Alarms, Other security devices, etc. Discounts for larger risks, Deductible, etc.
Third Party	Rate per mille on turnover or rate % on wage roll where manual work at third party premises	The individual risks will be divided by trade and ideally by sub-process	Adjusted for Limit of Indemnity, Deductible, etc.
Products Liability	Rate per mille on turnover	The separate product risks will be divided by trade	Adjusted for Limit of Indemnity; US & Canada exposures attract loadings

Test Yourself 5

Question 5

When insurance companies undercut each other to grab market share by reducing premium, it is known as ___________

A. Soft Market
B. Hard Market
C. Competitive Market
D. None of the above

On all risks, we will now examine the claims scenarios.

Initially we must remember that the insurer is in the business because he is willing to pay claims. We would, therefore, tend not to load for the single claim, unless the circumstances were unusual and showed poor management or some other underwriting weakness.

Where there is however a run of claims, we would examine the circumstances and liaise with the insured. Is it that all (or a majority of) claims have arisen from a single cause that has now been eradicated?

Example

Motor Insurance: Investigating a number of motor claims we find that they were all caused when a certain individual was driving. This individual has now left the company or been removed to a non-driving role.

Fire Insurance: Following a series of fires at the old premises, the insured has moved to purpose-built new premises of superior construction

There is always a temptation to look to recoup the losses when an insurer has a run of claims but they must be aware that competing insurers will be only too happy to take a piece of business away where it appears the risk management has improved the risk substantially.

Where a risk is big enough, we may look at a burning cost basis – this is a common rating method in Europe with a large Liability or Motor Fleet risk. Looking to see what the Claims Cost is per unit (in a turnover or wage roll base for Liability or per motor vehicle for a fleet).

Year	Total Claims – Paid and Outstanding (Rs.)	Number of Vehicles	Average Cost of Claim per Vehicle (Rs.)
04/05	12000000	50	240000
05/06	15000000	53	283019
06/07	4500000	57	78947
07/08	1600000	60	26667
08/09	18000000	61	295082
TOTAL	**51100000**	**281**	**181851**

Now we have an estimated claims cost per vehicle over 5 years of Rs. 1,81,851

If we work to a Loss ratio of 65% this should give us a premium of Rs. 2,79,770 for each vehicle in 2009/10

However, there are a few small comments to be made here

1. We need to build in the inflationary increases in the earlier years – for instance, the average cost of the claim in 04/05 (240000) will need to be brought up to 08/09 real terms to be fully accurate
2. We may need to investigate the trends in the claims – an unusual dip in 06/07 & 07/08 – was there any reason for this? Does it need to be factored in?
3. Element of Catastrophe reserve to be included

However, it does give a reasonable illustration as to how this method can be used for rating.

No Claims Bonus / Malus

In motor covers (and occasionally in other classes), there is a recognised scale of discounts for risks with no claims or limited claims – a **No Claim Bonus**

This is used in many countries to encourage the insured to drive carefully and, if there is a small claim, to consider treating that as "self-insured" rather than jeopardising his no claim bonus, which can be substantial after say 4 years of claims free driving.

As per the Indian practice, when the insurer settles a claim, the insured loses all previously accumulated No Claim Bonus. However, he can again continue to earn No Claim Bonus for claims free years at subsequent renewals.

Loading / Malus

There is also a reverse scenario where insurers load the premiums as per a published schedule when the claims experience is bad. Such loading of premium when the claims experience is poor is known as **Loading / Malus.** Conditions when such loadings are done and the amount of loading are disclosed in advance.

In many situations, certain caps are imposed on the loading. Indian Motor insurance, for instance, caps some loadings at 100% and some types of loadings at 200%.

Section 64 VB, Insurance Act 1963 – No Premium: No Cover

In many parts of the world, if the business is through an agent or a broker, the insurer will give the cover on credit with up to a 3-month period. However, in India the relevant rule is laid down under Sectio 64VB of the Insurance Act 1963 (copied below) which states that the insured MUST pay the premium before the cover starts.

Section 64 VB, Insurance Act 1963:
No risk to be assumed unless premium is received in advance.

64VB. (1) No insurer shall assume any risk in India in respect of any insurance business on which premium is not ordinarily payable outside India unless and until the premium payable is received by him or is guaranteed to be paid by such person in such manner and within such time as may be prescribed or unless and until deposit of such amount as may be prescribed, is made in advance in the prescribed manner.

(2) For the purposes of this section, in the case of risks for which premium can be ascertained in advance, the risk may be assumed not earlier than the date on which the premium has been paid in cash or by cheque to the insurer.

Explanation: Where the premium is tendered by postal money-order or cheque sent by post, the risk may be assumed on the date on which the money-order is booked or the cheque is posted, as the case may be.

(3) Any refund of premium which may become due to an insured on account of the cancellation of a policy or alteration in its terms and conditions or otherwise shall be paid by the insurer directly to the insured by a crossed or order cheque or by postal money-order and a proper receipt shall be obtained by the insurer from the insured, and such refund shall in no case be credited to the account of the agent.

(4) Where an insurance agent collects a premium on a policy of insurance on behalf of an insurer, he shall deposit with, or despatch by post to, the insurer, the premium so collected in full without deduction of his commission within twenty-four hours of the collections excluding bank and postal holidays.

(5) The Central Government may, by rules, relax the requirements of sub-section (1) In respect of particular categories in insurance policies.

Summary

- Pricing is critical to the success of any insurance venture. Underwriting profits should be a consistent target.
- Basic pricing – premiums in : claims out – leads to pure premium
- Pure premium needs adjustment for all the working expenses and normal outgoings of any insurer
- Technical rate and book rate are critical for long term underwriting profit
- Operational premium issues include rating, catastrophe loading and commercial discounting

Some important terms / definitions you have learnt in this chapter

a) Loss ratio
b) Pure premium
c) Technical rate
d) Burning cost

Answers to Test Yourself

Answer to TY 1

The correct option is **B**

To create this fund the amount of premium each factory owner would need to contribute is – Rs. 1 lac
Rs. 20,00,00,000 divided by 2,000

Answer to TY 2

The correct option is **D**

Investment income does not form part of the book price formula

Answer to TY 3

The correct option is **D**

Exposures will not be considered as an extra factor – they will be taken into account in the base calculation

Answer to TY 4

The correct option is **B**

The correct rate is 0.25%

Answer to TY 5

The correct option is **A**

When insurance companies undercut each other to grab market share by reducing premium it is known as soft market

Self-Examination Questions

Question 1

"The loss lighteth rather easily upon the many than heavily upon the few." – The English Act of Parliament in 1601. What does this best sum up?

A. Concept of the insurance pool
B. Concept of responsible underwriting
C. The need for more insurance companies
D. The need for responsible claims handling

Question 2

Pure Premium is defined as which of the following?

A. Total Amount of Claims Incurred per Year divided by the number of exposure units
B. Total Amount of Claims divided by Premium
C. Total premium Divided by the Total Claims
D. Total premium Divided by the number of exposure units

Question 3

Within the calculation of technical pricing there are a number of future trends the underwriter needs to consider – 4 are given below. Which one is incorrect?

A. Inflation
B. Claims made during the year
C. Technology
D. Legal Changes

Question 4

Which of the following is unlikely to be a rating / underwriting factor in Fire Insurance?

A. Construction
B. Fire Extinguishers
C. Building Security
D. Deductible

Question 5

The claims loading applied to a policy is known as ________

A. Claims Bonus
B. Claims Malus
C. Claims Fides
D. Claims Minus

Answer to Self-Examination Questions

Answer to SEQ 1

The correct option is **A**.

It is related to the concept of the insurance pool

Answer to SEQ 2

The correct answer is **A**

Total Amount of Claims Incurred per Year divided by the number of exposure units

Answer to SEQ 3

The correct answer is **B**

The claims will certainly be considered by the underwriter but not under the heading of future trends

Answer to SEQ 4

The correct answer is **C**

Building security is likely to be a Burglary rating/underwriting factor but not Fire Insurance

Answer to SEQ 5

The correct answer is **B**

The claims loading applied to a policy is known as Claims Malus.

CHAPTER 8

CLAIMS

Chapter Introduction

The main reason why people buy insurance is for peace of mind (usually the individual) or protection of a company's balance sheet (the corporate). Buying insurance gives a comfort that if something disastrous does happen then the insurance company will support the insured through the handling and settlement of the claim, so that the affected individual or company can once again stand on its feet.

A company's claims service is, therefore, the principal point of service as regards the insured. Failure in this area can cause irreparable damage to the insurance company's reputation; lead to loss of valued customers, and even lead to law suits being filed against the company.

The reverse of the above is a well handled claim, which could be rewarded by a happy customer by way of renewing his cover with that insurer year after year as also spreading a good word about the insurer; which might bring in new customers.

This chapter will take you through the basics of claims handling and the various stages in the claim settlement process.

Learning Outcomes

a) Understand the basics of a claim.
b) Work through the claim process.
c) Understand the process of claims management.
d) Identify some of the claim related main issues and problems.

Case Study

The terrorist attack of September 11, 2001 on the Twin Towers of the World Trade Centre in New York was the most expensive loss in the history of the insurance industry. Over 100 insurers around the globe had to shell out an estimated USD 40 billion or more dollars to settle tens of thousands of claims.

It is an extreme case study of so many facets of insurance claims:

- it resulted in numerous life insurance claims from the deaths of the people on board 4 aircrafts and people who died in the twin towers and outside it,
- it impacted aviation insurance in a big way,
- it changed the dynamics of property insurance (terrorism),
- it also impacted business interruption insurance, liability insurance and health insurance, etc.

The shock waves from this event will impact the pricing and availability of insurance coverage for years to come.

The above 9/11 terrorist attack case study highlights the importance of insurance and the claims settled by the insurance companies, which slowly but surely resulted in business regaining confidence and returning back to normalcy over a period of time.

1. Understand the basics of a claim [Learning Outcome a]

Claims

As a general rule; claims incurred constitute the largest cost for any insurer. Out of every Rs. 100 that the insurer receives in premium, he is likely to pay out Rs. 65 or more to settle claims, with the balance of Rs. 35 being required for covering the other expenses such as commissions, management expenses, etc.

A claim is also the prime time when the insurer can make the best impression on the policyholder (as the marketers call it – the moment of truth).

So, we have a dichotomy between the insurer attempting to reduce his claims costs, improve their bottom line and satisfy their shareholders and at the same time ensuring that the best possible service are offered to the customer and ensuring that he is fully indemnified within the policy wording and at the lowest possible cost.

What is a claim?

The payment of claims is the prime reason why the insurer is in business.
Insurance is an unusual industry compared to most other industries. In insurance business, nothing other than a policy document and a promise to pay an insured claim is given to the customer when he hands over his or her premium.

The benefit comes in:
1. for the individual, the peace of mind that the property and liabilities are insured; and
2. for the corporate, the satisfaction in knowing that the risks to the balance sheet are taken care of.

It’s the insurer’s responsibility to satisfy both the above by the fair and equitable handling of a claim, should an insured contingency arise.

Definition

Claim: a claim is a notification to an insurance company, requesting payment of an amount, on the happening of a specified event, under the terms of the policy.

What happens when a claim occurs?

The insured

An incident has occurred and there is a financial loss to the insured (for death, bodily injury, etc. in the event of personal accident insurance). The insured believes that the contingency is covered by an insurance policy and checks his or her policy.

Example

Situation 1

Motor Insurance: the insured is driving down the road, loses concentration and collides with an oncoming vehicle (the third party). By law, he is required to have Third Party Insurance for injury to the person in the other vehicle if he (or his driver) can be proved negligent. The third party insurance will also provide cover for damage to the other vehicle. But then what about his own vehicle? In that case, he will need to check whether he has **"comprehensive"** cover which will insure the damage to his own vehicle.

Example

Situation 2

Fire Insurance: there is a serious fire in the insured's factory. Unless deliberately caused by the insured (arson), it is likely that the fire policy will compensate for the financial loss in respect of the building damage; together with the damage to the contents (machinery and stock). The insured will need to check to ensure that there are no clauses or warranties restricting cover in certain areas or processes e.g. excluding claims where flammable liquids have been involved.

Example

Situation 3

Liability Insurance: the insured has visitors to his offices. An employee has negligently left a large box in the corridor immediately around a corner. One of the visitors comes in and trips over the box, fracturing her ankle. She believes that the insured is at fault and sues for damages.

Claims Conditions

The responsibility of proving that a claim falls not just within the policy terms but also that all the claims conditions are fulfilled, is entirely the insured's.

What the insured must do?

The procedure varies from insurer to insurer but the common practice is as follows:

Heading	**Comment**
Notice to the insurer - immediately	The insured must ➢ minimise the damage and recover any missing property ➢ inform the insurance company in writing ➢ get in touch with the relevant authorities (e.g. police, if it's a theft) ➢ Send any writ or summons and not admit ANY responsibility (if Liability)
Notice to the insurer – within a period (say 30 days)	The insured must ➢ put a claim in writing, detailing the amount lost or damages ➢ advise of any other insurance, possibly covering the loss

Provide detailed information to the insurer	The insured must provide all relevant information, books of accounts etc. to the insurer
Possession to the insurer – Property Claims	The insured must allow the insurer to take possession of any building or property that is the subject of the claim. However, this does not allow the insurer to abandon the property.
No admission of Liability – Third Party Claims	Where a claim involves a Third Party suing the insured, it is a condition that the insured must make NO admission of liability but pass an summons, writs, claims for damages, etc. directly to the insurer

Test Yourself 1

Question 1

Rajesh's car collides with another car and the other car's driver is injured. Who will pay for the claims of the other driver?

A. Rajesh will pay from his own pocket.
B. The other driver will have to pay on his own for the treatment costs as he does not have any insurance
C. Third Party Insurance Pool
D. Rajesh's insurance company

2. Work through the claims process [Learning Outcome b]

This is a relatively consistent process, involving a number of well-defined steps as below. The basic objectives are to:

1) provide efficient and effective customer service; and
2) meet the needs of the customer (or third party claimant)

in accordance with the terms and conditions of the policy, at the lowest cost (i.e. the actual cost to settle the claim and the costs of administering the claim).

A. Contingency occurs

An event (mishap) has happened, which the insured believes, falls within the scope of his / her policy.

⇩

B. Initial intimation of a claim

It is a condition of most insurance policies that the client has to provide initial details of the claim in writing, immediately when it happens. This enables the insurer, in complex claims, to get on the site as soon as possible.

At this time, after verifying that the claim falls under the concerned policy, the insurer will register the claim with the initial details, such as:

1. Policy number
2. Date of claim occurrence
3. Location of claim
4. Brief circumstances of claim
5. Preliminary reserve – a rough indication of potential costs

Depending on the size / complexity of the claim, the insurer may wish to appoint an independent Loss Assessor to get immediately involved with the investigation of the claim

Example

If there is a severe fire, the insurer would want his Loss Adjuster and Risk Engineers to reach the site immediately, to ensure that the loss to the insurer can be reduced as much as possible. For very good reason, the Fire Brigade has a prime responsibility to save **lives** first – not look after property. Without hindering the Fire Brigade, prompt arrival of the risk engineers and action to save the property, can reduce a claim significantly.

⇩

C. Forwarding of further details

Under many policies, the insured has a responsibility to report a claim immediately to the insured. However, he or she will have little by way of detail, depending on his own investigation of what happened and what damage has been caused.

The insurer usually, therefore , gives the insured more time to gather all the facts, usually requesting this in a formal claims form, which leads the insured to confirm the basic details such as:

1. Policyholder details – name, address, policy number, etc.
2. Location of claim
3. Full description of circumstances including time as well as date

It will also ensure that the policyholder advises of specific information such as whether there are other policies in force.

The insurer is likely to formally acknowledge the claim but will not, at this stage, comment on the potential amount payable, although the insurer may confirm that *in principle*, the policy will respond to the claim. The insurer will also take the decision regarding Loss Assessors, if not already done.

D. Setting up of claim reserves

Following these fuller details, the insurer will firm up on the claims estimate put against the claim at the time of immediate notification. It is critical that as accurate a figure as possible is placed against the claim, as it is likely that this will be immediately fed into the reporting structure, in order that the senior managers in Claims, Underwriting, Finance, etc. can see the overall picture for the client, portfolio and company.

This is particularly crucial when the periodic reports are being compiled or such tasks, as arranging reinsurance, are underway

E. Investigation

Once sufficient information has been received, the insurers will examine the facts to check aspects such as the following:

- claim is covered under the policy
- policy conditions have been complied with
- whether the amount claimed for, is within policy sum insured / limits

This may involve external specialists and experts in fields relating to the claim e.g.

- valuers – e.g. with works of art, classic cars, etc.
- investigators – tracing stolen high-value vehicles
- consultants – engineering consultants to check work methods are applied accurately

This may require further supporting documentation / follow-up communication leading to agreement on full admissibility of the claim and the quantum (amount) of loss.

F. Offer / negotiation or declinature

With agreement on claim admissibility and the quantum, will come an offer to the insured, relating to settlement of the claim.
If settlement offer is accepted, the claim is settled.
If settlement offer is declined then both parties move into a negotiation stage with discussions, until an agreement is reached (see later note regarding arbitration)

If the risk is declined - and this would have been done at senior level - then this should be communicated to the insured as soon as possible, with relevant reasoning. It is appreciated that the declinature may have a significant impact on relations with the policyholder.

⇩

G. Final Settlement

Once agreement is reached on quantum etc. the claim will be settled accordingly. This could be done by cheque or it could be through a number of other formats such as:

- Reinstatement
- Rebuilding
- Restoration
- Repair

The final payment figures will be entered against the claim with any outstanding estimates replaced or reduced to zero.

The insured will be asked to confirm that he or she is happy with the full and final settlement. Within the nationalized era, this was by way of a **'discharge voucher'** and had a standardized format. With the liberalization, insurers have their own format but the aim will be the same.

⇩

H. Closure

Once the settlement issues have been completed then the insurer will look towards

- Closing the file
- Examining potential of recovery – this could be by subrogation, contribution, salvage, etc

Test Yourself 2

Question 2

The sharing of a claim between two insurers is called ______________

A. Subrogation
B. Contribution
C. Reinsurance
D. Reinstatement

Information Technology Systems

During the period of nationalisation, all records were maintained manually. However, today, the IT systems supporting the claims process are critical.

The IT systems will:

- help in delivering the service expected by the policyholder and promised by the insurer with easy access to files, file tracking, etc.
- facilitate the optimum claims management approach
- capture claims data accurately i.e. updated reserves to feed the reserving and management information / pricing processes elsewhere in the operation
- assist in the identification of potential fraud or error by issuing warning messages when certain parameters are triggered
- ease the recovery of all amounts due to the insurer in respect of claims paid e.g. excesses or deductibles, recoveries from other insurers or third parties, reinsurance recoveries, etc.

Management Information / Claims Coding

In the modern insurance world, it is critical that the operating functions and management keep a track of what is happening.

Fortunately, with the IT systems mentioned above, much of this information can be delivered in real time; as long as the input data have been entered accurately – remember GIGO.

Definition

GIGO: Garbage In, Garbage Out is a phrase in the field of computer science or information and communication technology. It is used primarily to call attention to the fact that computers will unquestioningly process the most nonsensical of input data (garbage in) and produce nonsensical output (garbage out). It was most popular in the early days of computing, but applies even more today, when powerful computers can spew out mountains of erroneous information in a short time.

(Courtesy : Wikipedia)

Sophistication of the system, results in generating detailed reports. Detailed history can be built up of claims costs, their cause and the segment of the policy cover impacted, particularly with the complex and, packaged type of product now commonly sold (i.e. a single contract covers a range of risks, both property and liability).

This history can then be analysed to assess profitability not just at product level, but also at separate cover level within the product, assuming that the premium has been built up by element of cover, so that the relative profitability of each segment can be determined.

In theory, a good understanding of profitability combined with a good knowledge of future developments in claims impact and frequency, should enable more accurate (profitable) pricing of products in the future.

Example

In a Motor Insurance claim we would expect that the information that may be gathered could include the following:

- Date of Accident

- Time of Accident
- Vehicle Details e.g. Registration Number
- Driver Details e.g. Name, Age, Gender
- Coded Description of Accident / Loss
- Coded Details of Damage
- Coded Details of Injury
- Third Party Details

Proof of Loss

As mentioned earlier, the "**onus of proof**" is important. Onus of proof is a legal term relating to the person who must provide the evidence. It is a legal obligation to provide proof of what is alleged and, it lies with the insured.

However, usually most insurers are not unreasonable, and will only require reasonable proof, not absolute proof of everything. As much proof as possible always helps, but once the claimant has done all that they can, they have met the requirements of the policy.

Example

For example, if the policyholder claims for a theft, then they must show evidence of that theft. It is not enough to simply say that it happened; they would be expected to explain how the thief broke in and what property was taken. The explanation should provide reasonable proof, not necessarily absolute proof. Of course, the insurer may have concerns over whether the loss is covered under the terms of the policy. They may allege that the locks or alarm fitted to the premises, breached security conditions on the policy and they may seek to decline the claim for this reason.

In this example, the onus of proof switches to the insurer to prove that the cause of the loss was a breach of the condition. The onus of proof is stronger for the insurer. The evidence from the insurer must be strong enough, to convince a judge. If they cannot provide this proof then the claim will succeed. Of course, even if the insurer is convinced that the incident has occurred, they still need to consider other factors.

Test Yourself 3

Question 3

The responsibility on proving the claim is covered rests with ___________

A. The third party
B. The insurer
C. The insured
D. All of these

3. Understand the process of claims management [Learning Outcome c]

Total claims management capability is a key competence of a successful insurer. Key areas in the claims process mentioned above; where management control will need to be tight include:

Acceptance: not every claim / incident notified by a policyholder is necessarily a valid claim under the policy. The insurer needs to have quality people assessing the validity of the claim against the policy wording and terms, in order to decide whether to accept the claim.

- **Management & quantification:** taking control of the resolution of the problem, identifying and delivering the most cost effective solution within the terms of the policy, accurately identifying the total cost of the solution. This phase may involve significant input from third party suppliers to mitigate the damage, assess and evaluate solutions, and to deliver the agreed solution.
- **Settlement and closure:** finalising the claim, making payments to suppliers, third parties and / or the policyholder and closing the claim once all amounts are settled. The insurer's principal interest, when notified of a claim, is to take control of the claim in its entirety. In this way it can ensure that:

a. Damage / loss is minimised by early action (e.g. emergency repairs to buildings to prevent further damage).
b. The most cost effective solutions are provided (e.g. preferred repairer / supplier arrangements, replacement goods rather than monetary value).
c. The overall claim and time taken to settle is managed in the most efficient way possible.

In practice however, an insurer may not be able to establish direct and complete direct control over a claim, e.g. when a third party is involved - a policyholder being at fault in a car accident involving another vehicle or property. In such a case, the other insurer / party can take control of that element of the claim, which relates to them and then seek to recover from the policyholder's insurer. The insurer can then only challenge the quantum of the claim submitted by / on behalf of the third party, specially if that is clearly overstated, and then, the insurer has little opportunity to manage the total cost. Some insurers may offer to provide full claims solution services even to third parties, where their insured is at fault, to enable full control over the claim to be established.

Determining liability / acceptance of the claim

The first question the insurer needs to determine is whether the claim is valid under the terms of the policy, and if yes, whether there is any other party, who should share or take full liability for the loss being claimed for.

Example

In a motor car accident involving damage to a policyholder's vehicle and a third party's vehicle, the questions would come down to:

- What was the policy cover?
- Who was at fault? If the other party was shown to be responsible for the accident, all costs of the claim are then potentially recoverable from the third party or their insurers.

Problems can arise in assessing the eventual cost to the insurer if, either, fault cannot be clearly determined or the other party is uninsured and held to be at fault.

In certain cases, the extent of cover and whether a particular event was covered by the policy, can be much more complex. At the extreme end, the exact wording of the policy as issued, will be used in a Court of Law, if necessary, to resolve the issue.

It should be realised that the onus is on the underwriter to specify the coverage of the policy as clearly as possible at the outset itself. If there is any ambiguity, it is almost certain that the court will give the benefit of doubt to the policyholder.

Quantification: Underinsurance (Property Insurance)

Most insurance policies will specify a 'sum insured' or other limit on the value insured under the policy.
It is the policyholder's responsibility to determine whether this is adequate for their needs. However, there are times when the actual value at risk is greater than the sum insured. In such cases, the insurer has the right to settle the claim in the same ratio that the sum insured bears to the total value . This is so because the insured has not paid the premium for the full value at risk and so, cannot expect the claim to be settled fully.

Example

Sum insured on the building : Rs. 10 crore

True value of the building : Rs. 15 crore

Claim submitted for partial damage of Rs. 6 crore.

Settlement will be based on the ratio of 10 : 15

$$\frac{\text{Sum Insured (10 crore)}}{\text{True Value (15 crore)}} \times \text{Value of claim (6 crore)} = 4 \text{ crore}$$

Underinsurance can arise for a variety of reasons, although is usually a result of the policyholder incorrectly assessing the value at risk, or specifying a sum insured limit that was inadequate for their needs.

The condition prescribing underinsurance is "Condition of Average".

Quantification - complex claims

Many complex claims can take a long time before they could be fully quantified. In the case of liability / injury claims this can be a period of years after the date of the incident, and often result in legal cases where the final award i.e. the indemnification amount, is determined by the Courts.

Even complex property damage claims can take a long time to fully quantify where the cost of rectification / rebuilding and the time required to complete the work, can be difficult to assess, and may take months or even years in very complex cases such as historic buildings or complex engineering or chemical plants.

The issue becomes one of assessing the most accurate reserves to establish at any point in time, and keeping them up to date. ,

Test Yourself 4

Question 4

ABC building is insured for Rs. 12 crore and the Machinery for Rs. 3 crore. The true values are Rs. 18 crore and Rs. 4 crore respectively. There is a serious fire and the building suffers damage to the tune of Rs. 10 crore and the machinery, Rs. 3.6 crore. What is the payable claim amount?

A. Rs. 8.10 crore
B. Rs. 9.36 crore
C. Rs. 9.28 crore
D. Rs.10.20 crore

Arbitration

Arbitration is introduced in property claims, where the insurer has admitted liability under the policy but there is no agreement on the amount being offered.

Liability claims present their own problems may have to deal with intangibles. However, decision of the arbitrators is normally obtained before approaching a court of law.

The arbitration condition does vary from company to company and cover to cover with some examples being as below:

- Number of arbitrators can be as low as one as long as both parties agree but common numbers are frequently two (one proposed from either party) with a third acting as the umpire.
- Other conditions will relate to the location of the arbitration – usually country of policy location - and language the proceedings will be conducted in – usually English.

Modes of Settlement (Property Insurance)

1. Repair and Replacement

Under the Policy Conditions, the insurer has the option of repairing or replacing the damaged or destroyed property.

Under this condition:

a) Such repair or replacement may not be exact e.g. materials have changed, local regulations may prohibit certain items, etc.
b) The costs of repair or replacement will not exceed the sum insured.
c) The repair or replacement will be completed in a reasonable manner.
d) The insured will be responsible for giving any requested plans, specifications, measurements, etc. that the insurer may require to complete the repair and replacement (at the insured's cost).

2. Reinstatement

The objective of insurance, as specified in most policies, is to reinstate the policyholder to the position they were in, prior to the claim event occurring.

Example

When a policyholder suffers loss or damage to a five-year-old item such as a piece of manufacturing plant, item of furniture, etc. the insurer is responsible for compensation up to the level of a five-year-old item, not a brand new one.

However, in many property policies e.g. Fire Insurance on commercial property, the insurance policy specifically allows for the replacement of items lost or damaged on a 'new for old' basis, i.e. all items that are to be replaced will be replaced by brand new goods, even if the original items were not new.

This is partly:

- **consumer driven:** the value of a three year old video recorder or TV may only be a small fraction of the new price, and the policyholder would be unhappy having to pay the difference, in order to replace it with a new one themselves; and partly
- **insurer driven:** it would cost the insurer a lot of time and effort to calculate the current value of a wide range of damaged articles. Also, identical replacement goods would not be readily available. Further, policyholders are much more likely to inflate the size of the claim, if they think that they will only receive a fraction of the total replacement value claimed, requiring much more investigation and argument.

The condition is that the sum insured **MUST** be on the new replacement value basis and the premium calculated on this; so the insurer receives the correct premium and also avoids client issues at claims time, around the calculation of the appropriate depreciation.

Repair

A further option is for the insurer to insist on repair rather than replacement, where this is economically valid and the repaired item is "fit for purpose" and has the same economic value as a replacement item of similar age / wear, even where the insured would prefer replacement.

Write-Off

Where the repair of an item is greater than the economic value of the item, the insurer can insist on the item being written off and a payment based on the 100% sum insured or equivalent - even where the insured would prefer for it to be repaired.

Definition

Write-off is also used in vehicle insurance to describe a vehicle, which is cheaper to replace than to repair, sometimes colloquially referred to as being "totalled" (a total loss).

One insurer quoting that ".....the insured car is declared a write-off when in our opinion, it is so badly damaged that it would not be either safe or economical to repair or if the policy covers theft, when it has not been found within 14 days of you reporting its theft to us and we are satisfied that the claim is in order"

(Courtesy : Wikipedia)

Modes of Settlement (Liability Insurance)

The different classes will naturally vary as to the claims settlement and these should be examined independently. However, one major policy we will look at now is the liability cover. Here, the payments are not made to the insured but to the Third Party claiming damages from the insured's negligence. There will also be payments made in respect of legal fees that the insured has incurred – although these will be normally controlled by the insurer and paid direct to the legal team

Claim recoveries (amounts due to the insurer in respect of claims paid)

In many claims, there will be an option for the insurer to recover some of the amount from the insured or a third party.

Typically, the main areas for recovery are:

Type of Recovery	Recoverable from	Comments
Excess and Deductible	Insured	Many insurance policies have stated excesses or deductibles - the amount the policyholder must contribute towards a claim. This may be relatively low for a household policy e.g. a few hundreds of rupees, or could be hundreds of thousands of dollars for a large professional indemnity policy.
Subrogation	Third parties or their insurers	Where a third party can be shown to be at fault in causing the loss / claim, then under the insurance principle of subrogation, the insurer can take over the insured's legal rights to recover the cost of the claim from the offending third party and / or their insurers. The key issue here is establishing fault and getting the other party to accept liability. Fault can often be difficult to prove categorically, and many court cases result from attempts to ascertain liability for incidents leading to a claim.

Contribution	Other Insurer	There will be times when the same property is insured by two different insurers under different polices. As long as there is more than one policy covering ➢ same property, ➢ same interest, ➢ same peril the loss will be shared proportionately between the insurers concerned (one insurer will control the claim and then recover appropriate amount from the other insurer/s.)
Reinsurance	Reinsurer	Where a policy is individually (facultatively) reinsured, a recovery can be made from the reinsurer in accordance with the terms of the policy.

Example

Subrogation: the most common example of this is the car accident where there is no fault of the policyholder but claims are paid for the damages to his or her vehicle under the terms of the comprehensive policy. In this instance, once the claim is settled with the insured; the insurer can seek recovery from the , driver of the other vehicle who is responsible for the accident or their insurer.

Example

Contribution: a typical example is a camera, lost or damaged while on holiday which may be covered by both a Household Contents Policy and a separate Travel Policy. The insurer who handles the claim can recover a proportion of the cost from the other insurer.

Test Yourself 5

Question 5

A subrogation claim is recovered from the Third Party and/or which other party?

A. Client's insurers
B. Third Party's insurers
C. Reinsurers
D. Third Party's Reinsurers

Leakage

Definition

Leakage is the term for any additional costs incurred by the insurer beyond those necessary to fulfil its claim obligations under the insurance contract, excluding fraud. Thus, it covers any inefficiencies or errors in the handling or settling of the claim, failures of service or replacement goods suppliers to act efficiently or according to their service contract, or any other unnecessary cost.

Examples of leakage include:

- failure to recover excesses / deductibles from policyholders
- failure to recover amounts reclaimable from third parties, other insurers, reinsurers, etc.
- unintentional overpayment of the claim (e.g. payment in excess of limits of cover or amount claimed)
- excessive claims administration costs, inefficiency, etc.
- failure to decline claims that are not covered by the policy.

Leakage is largely preventable through effective management. Most insurers will establish some form of audit or benchmarking process, to regularly assess the effectiveness of their claims handling service and the level of leakage experienced. From this, actions and targets can be established to seek to improve efficiency and reduce leakage.

4. Identifying some of the claim related main issues and problems

[Learning Outcome d]

Ex-gratia Payments

There are times when a claim is not covered but it is felt by senior management that a payment may be made to the insured as a goodwill gesture – in insurance this is termed an "ex-gratia" payment.

Such payments are totally a matter of grace on the part of the insurer, as there is no legal obligation under the contract.

Authorisation to make such a payment must be made at a very senior level and should only be made where it is clearly in the insurer's interest to maintain goodwill, retain profitable business, etc.

Example

- A very longstanding personal customer with no previous claims, is told at the time of a claim event that he is underinsured, which is quite possible due to inflation over many years. In such a case, as a goodwill gesture for the loyalty and past profitability of the customer, the insurer might consider an ex-gratia payment to cover the underinsured element of the claim.
- A broker has been bringing significant amount of profitable business to an insurer. Now, one of his corporate clients, finds that due to a misunderstanding or administrative error, they are not covered for a particular claim event. In such a case, the insurer may offer an ex-gratia payment.

Claims fraud and fraud prevention

Fraud ranges from mild overstatement of the value of items lost or damaged, through to organised criminal activity, designed to obtain large sums of money.

Every insurer, therefore, faces a constant challenge to minimise the cost of fraudulent claims, while also providing the desired level of service and claims solution delivery for all valid claimants. Insurers will use a range of techniques to seek to identify fraud, which vary depending on the insurance cover / product offered. These include:

- fraud awareness training for all claims staff to enable potential fraud to be detected, as the claim is handled
- computer programmes that highlight potential fraud, based on defined criteria, identified from previous fraud experience
- the establishment of specialist internal fraud investigation departments
- the employment of external fraud investigation services
- sharing of claims data with other companies via shared databases e.g. CUE - the Claims and Underwriting exchange Database in the UK, where the majority of UK insurers share data on all Household and Motor claims made
- co-operation with police, government, industry, etc. and all other anti-fraud initiatives.
- using contracted replacement goods and services suppliers, to minimise betterment fraud (the claimants seeking to be put into a better position than they were before the event) and supplier overcharging / fraud (the local supplier, appointed by the claimant, either overcharging ('because its an insurance claim') or charging for work not done.

Insurance Fraud

Insurance fraud is widespread and the situation continues to deteriorate. For example:
In the UK, ABI research suggests that 40% of consumers think it acceptable to exaggerate a claim, and 29% even think it acceptable to invent one.
In the USA, the Insurance Services Office estimates that the cost of fraud to the property and casualty sector is $24 billion p.a., representing 10% of total claim payments.

Test Yourself 6

Question 6

Which of the following is an ex-gratia payment?

A. Payment made when risk not covered under policy
B. Payment made when policy voided
C. Payment made when policy cancelled
D. None of these

Summary

- Claims handling is the most important service an insurer can give, as regards customer service.
- At the same time, poor claims handling can also hit the company's bottom line and shareholder profits.
- A claim can be extremely simple or extremely complex to handle but in any case, it's crucial the insured follows the claims conditions in the policy.
- Claim process is relatively consistent in big and small claims – initial intimation, gathering of facts, investigating the claim, declinature of claim, negotiation, settlement and the closure.
- Correct classification of the claim details is very important for management information and managing the portfolios.
- Leakage is a serious issue with any insurer. Leakage refers to where the claims team forgets to recover all that is owed to it i.e. recovering the excess, exercising its subrogation rights against a third party, obtaining contribution from another insured or obtaining cash against salvage items.

Some important terms / definitions you have learnt in this chapter

a) Claim
b) GIGO
c) Write Off
d) Ex Gratia payments
e) Leakage
f) Recoveries

Answers to Test Yourself

Answer to TY 1

The correct option is **C**

The claims of the other driver will be paid from the Third Party Insurance pool.

Answer to TY 2

The correct option is **B**

The sharing of a claim between two insurers is called contribution

Answer to TY 3

The correct answer is **C**

The onus of proving a claim rests with the insured

Answer to TY 4

The correct answer is **B**

ABC Building is insured for Rs.12 crore and the Machinery for Rs.3 crore. The true values are Rs.18 crore and Rs. 4 crore. The building suffers damage to the tune of Rs.10 crore and the machinery Rs.3.6 crore.
The claim consists of 12/18 X 10 (6.66) plus 3/4 X 3.6 (2.7) giving us a total of 9.36 crore

Answer to TY 5

The correct option is **B**

The insurer recovers subrogation amounts from the Third Party and / or Third Party's insurers

Answer to TY 6

The correct option is **A**

An ex-gratia payment relates to the event when the claim is not covered but for business reasons, payment is made

Self-Examination Questions

Question 1

When there is a possible claim, the insured must initially advise the insurer within what time period?

A. Immediately
B. 1 week
C. 2 weeks
D. 1 month

Question 2

A fire deliberately caused by the insured is called _____________

A. Immolation
B. Malicious Damage
C. Deliberation
D. Arson

Question 3

Which of the following describes Quantum?

A. The time the accident happened
B. The likely cost of the claim
C. The number of claims
D. The size of the claims

Question 4

Leakage relates to which of the following ________

A. Water leaking from damaged pipe
B. Cash losses from employee embezzlement
C. Relates to claims losses which can be recovered through subrogation, excess etc
D. Drop in claims reserves

Answer to Self-Examination Questions

Answer to SEQ 1

The correct option is **A**.

The insured must advise the insurer immediately

Answer to SEQ 2

The correct answer is **D**

Arson is the criminal offence of burning ones own property (usually to defraud)

Answer to SEQ 3

The correct answer is B

Quantum is the likely cost of the claim

Answer to SEQ 4

The correct answer is **C**

Leakage relates to the losses a company has every right to recover but does not i.e. contribution, subrogation etc.

CHAPTER 9

INSURANCE RESERVES AND ACCOUNTING

Chapter Introduction

In this chapter, we will look at one of the main activities that a claim department has to perform to maintain discipline and also meet statutory requirements. We will see how an insurance company sets aside funds for claims that may arise in future. We will also learn how the reserve fund money is invested to earn maximum returns.

Learning Outcomes

a) Understand the different types of reserves maintained by insurance companies.
b) Learn about the reserving process followed by insurance companies.
c) Examine the premium investment strategies followed by insurance companies.

1. Understand the different types of reserves maintained by insurance companies

[Learning Outcome a]

The Management of Reserves

Poor Reserving

"There is no acceptable excuse for poor reserving. Unless we are accurate with our reserves they will threaten our very existence."

(Tony Lancaster – CEO, Groupama UK, CII Conference, 2001)

Insurance is an unusual industry in that a majority of its costs are both delayed and uncertain and it is critical, therefore, that all insurers estimate the future liabilities as accurately as possible and put aside (reserve) money to meet them.

Furthermore, since it is, by definition, the larger claims that take time and are difficult to judge, the total amounts required to be reserved per year can be enormous.

Example

Size of Reserves: In a mature property and casualty operation, these technical (or specifically allocated) reserves may be larger than the annual premium income and can be up to 2 to 3 times the premium in liability classes.

Definition

Technical reserves: the assets that an insurance company maintains to meet future claims or losses.

The technical reserves required can be classified as follows:

a) Reserves for unexpired risks
b) Reserves for incurred but unreported claims
c) Reserves for outstanding claims
d) Fluctuation reserves

Technical reserving is critical to any insurer and directly impacts profitability and solvency; the two principal dangers being:

1. Under-reserving is where an insurer may take in an over-optimistic view of future claim payments. Initially it will boost profits and seem like the underwriting strategy and pricing is correct; however, over time there will be difficulty in paying claims and the insurer will have to call upon shareholders' funds (sometimes known as free reserves) reducing its solvency.

Case Study: Independent Insurance, UK

Independent Insurance (estd.1903) was reinvented in 1987 when it metamorphosed into a forward thinking, fast-growing, broker-only company. In 1996, Independent combined with a merchant bank to buy the UK business of US insurer Allstate. It had become a Public Listed Company in 1993 and by 2000 had grown significantly:

- 2,000 employees in 16 locations in the UK as well as in Europe.
- 500,000 individuals on home and motor policies,
- 40,000 commercial customers
- premiums in excess of £850m

The company wrote property, liability, home and motor business in the commercial and personal sectors when it moved into the highly competitive London market.

In early 2001, problems regarding liquidity, claims ratios and need for new capital emerged. There followed a downward spiral of director resignations, failure to raise capital and a general failure of credibility. In June 2001, the liquidators were called in after unquantifiable losses from claims surfaced, many of which had never been entered in the company's accounts.

While many were surprised at its collapse, several brokers and insurers were not. Almost since its relaunch in 1987 there had been market rumours of accounting irregularities and other practices, which no one managed to substantiate.

The details of what went wrong and who was to blame are still being argued over. The fundamentals for failure were attributed to excessive growth, **inability to reserve adequate premiums for long-tail liabilities**, insufficient reinsurance and **under-pricing**.

(Courtesy Ian Youngman FCII)

Test Yourself 1

Question 1

Reserves for unexpired risks come under the heading of which of the following?

A. Accounting reserves
B. Technical reserves
C. Unexpired premium
D. Asset Liability Reserves

Stakeholders

With regard to a company's reserving practices, there are a number of stakeholder groups who will take close interest – albeit from different perspectives. These stakeholders can be detailed as follows:

1. Shareholders

The major interest a shareholder will have is to see his or her investments increase and the company stay viable, solvent and attractive to the market. They will be kept informed as regards the company's reserves through the Annual Report and Accounts, together with the quarterly / half-yearly reports.

They will look for the company to be adequately reserved to ensure its future prosperity and avoid nasty shocks - they will be less than happy if under-reserving results in a requirement for significant reserves.

On the other hand, over-prudent reserving will reduce the money available for distribution as dividend or available for new investment and therefore, will not be welcomed.

2. Government / Regulator

A government may consider a company's reserving from two distinct standpoints.

a. As a **regulator** the Government would like to see prudent reserving in order to:
   1. protect the customers from company failure
   2. protect the insurance market from instability and the burden of funding corporate failure
   3. avoid future calls on the companies' capital when solvency is threatened

b. As a **collector of taxes**, conversely, the Government would prefer that taxable profit is not delayed or avoided by being placed in reserves. For these reasons some governments have set down rules about making a 'best estimate' of reserves and their observance has to be confirmed in the annual audit.

3. Underwriters

The importance of claims experience in the pricing process was mentioned earlier.

1. Underwriters study the pattern of reserves development to understand the true cost of claims for whole classes of business to determine the appropriate pure risk premiums going forward.
2. they will use specific claims histories on cases which are individually underwritten

Accurate reserving is, therefore, essential, although in reality it is impossible to fully predict the economic, legal and regulatory impacts on claims which may not be settled for years.

4. Insurance Company Management

Reserving is also of great importance to company senior management as it:
1. indicates the relative profitability of various parts of the portfolio
2. highlights trends
3. provides an early warning of future problems

Types of Technical Reserves

There are two basic types of technical reserves: those relating to **premiums** and those relating to **claims**. Although the actual terminology may vary, the following would be recognised in most companies.

1) Premium Reserves

a) Unearned Premium Reserve

Since all the policies do not renew at the same time and do not tie in with the end of the financial year, there will be some amount of premium that is "unearned" at the time the accounts need to be finalised.
For example, if the financial year is the beginning of April and a policy was taken out only 3 months earlier at the beginning of January, there will still be 9 months left of potential claims and "unearned" premium.
The unexpired proportion of all premiums is, therefore, held until expiry in an Unearned Premium Reserve.
In practice, expenses are deducted from written premiums and the resulting net figure is used to calculate reserves on a monthly or even daily pro rata basis.

b) Unexpired Risk Reserve

This is a reserve that is no longer commonly used. If an insurer wrote premiums during a year which, in retrospect, are considered to be inadequate because of, say, a soft market, a reserve may be set up for the shortfall. This is called an Unexpired Risk Reserve.
If an insurer has to set up such a reserve, questions really ought to be asked why it has changed its mind about rates so soon after underwriting the business.

2) Claims Reserves

Outstanding Claims Reserve

This represents the money put aside for paying claims on business that has been written, whether or not these claims have been reported to the insurer. There are two separate parts:

3) Open Claims Reserve

The open claims reserves are the ones that have been reported, entered onto the system and a formal reserve has been input for each one.

4) IBNR Reserve

In addition to this, every insurer will have claims that, for some reason or other, have not yet been reported and the insurer does not know about. The term for this is IBNR i.e. these are claims that have been **I**ncurred **B**ut **N**ot **R**eported.

This is one of the main problem areas for general insurers. It is relatively easy to make a reasonable assessment of claims that have been reported. At the very minimum, an insurer can apply an average cost for the class of business for any claim arising. The next difficulty arises when the insurer has to speculate what might happen in the future. Typical reasons for an insurer to set up IBNR reserves are detailed below.

Another claims factor which may be included in the IBNR reserve is the provision made for any increase on the original estimate for open claims.

Case Study – Reserving for Asbestos

Asbestos is a naturally occurring mineral with remarkable properties, which have led to it being used in a wide range of industries. It is fire and chemical resistant, an excellent insulator, a reinforcing additive for cement and motor vehicle brake linings, and it can be woven into textiles. Its disadvantage, which eventually resulted in its abandonment, is that it forms extremely fine fibrous dust particles which may cause the degenerative lung disease, asbestosis or possibly the rare cancer, mesothelioma up to 40 years after the exposure.

Asbestos related diseases have given rise to many claims on employers, public and product liability policies for producers, distributors and users of asbestos products.

Recently, the frequency and volume of claims have been increasing rapidly, particularly in the USA, where more than an element of emotion has affected the court awards and the fact that judges do not appear to require the disease to have actually manifested itself. In recent cases, workers have received damages in excess of $1 million merely for the emotional distress of having been exposed to asbestos. The awards to actual disease sufferers are even larger e.g. one mesothelioma claimant has received $33 million. In the UK, similar cases are being settled at about £150,000. The effect on the P & C market in the USA has been little short of crippling.

Many companies have had to reserve hundreds of millions of dollars for past exposures, and regular strengthening of these reserves shows no sign of ending. Current reserves for asbestos related claims already run into hundreds of billions of dollars.

5) Claims Equalisation Reserve

In some countries, insurers are permitted to set up a reserve to smooth the overall result. In years, when claims experience has been favourable, an amount is put into a reserve from where it can be withdrawn in poor years. In theory, it is an in-house method of reducing the impact of catastrophes. In practice, some companies may treat this so called equalisation reserve as a tax management tool.

Test Yourself 2

Question 2

IBNR stands for what?

A. Income Before Net Reported
B. Incurred But Not Reviewed
C. Incurred But Not Reported
D. Investment Before Net result

2. Learn about the reserving process followed by insurance companies

[Learning Outcome b]

The reserving process at operational level is extremely simple in theory but can go badly wrong in practice. The whole purpose of the reserving policy is to ensure that the most reasonable estimates of the reported claims are made and can reflect the ongoing performance of a single client, a portfolio and the company in general.

Usually in the modern market, the estimate is to be input by a claims handler into the system.

Smaller claims, simpler risks e.g. motor, health, etc.

Within the commoditised classes, the figure to be input (if there is no obvious accurate figure already) is likely to be based on an average figure from past experience. Issues such as inflation are built in to make it as realistic and up-to-date figure as possible.

Larger and more complex claims

This will be controlled by a more experienced handler and by gauging the claims circumstances and using their own experience; they should be able to make a subjective judgement on the estimate.

It is crucial that the claims reserves are revisited regularly to ensure that the figures are as up-to-date as possible.

The system will then hold and total up all claims reserves in real time, to produce the open claims reserve.

The next step is for the claims professionals and actuaries to:

- bring the data together
- break it down into practical sub-classes
- review and refine it
- build in provisions for IBNR
- construct auditable reserves

The selection of sub-classes is critical if any subsequent analysis is to be meaningful. For this reason, there are at least three aspects to bear in mind as regards the sub-classes. They should:

1. be as **homogeneous** as possible, so that the data can be as reliable as possible
2. **not be too big** as it will give the underwriters difficulty in premium setting
3. **not be too small,** or the law of large numbers will not apply i.e. statistical variances will be large

Challenges

A significant issue is that of building in the IBNR and the reported claims development into the sub-class reserves. One approach is to look at the past claims experience in the sub-class, apply this to the data and then project into the future.

However, there are limitations

1. in a changing business environment
2. in long tail classes
3. where there is little relevant applicable claims experience (e.g. in new and emerging risks)

The remedy in such circumstances is to try to develop a deeper understanding of what drives claims, see how these factors are likely to change in the coming years and then make a judgement on how this could affect the reserves. Where possible, the reserver should also seek to identify steps that could be taken to manage down the eventual costs.

To analyse the pattern of claims, perhaps the most widely used tool is the Chain Ladder.

Triangulation or Chain Ladder

The Triangulation or Chain Ladder technique is a simple operation to give an idea of the claims development in a risk or sub-class over a number of years. The idea is to display and compare the development of claims from different years, using tables usually in the shape of a triangle.

A simple grid for claims paid on a property account is shown below. This particular example records the year of reporting and the amount paid out in the successive years - known as the years of development.

Claims paid in lakhs	Year of Development						
	0	**1**	**2**	**3**	**4**	**5**	**6**
1998	938	841	740	605	328	105	88
1999	1191	906	781	635	461	205	--
2000	1183	1038	848	701	564	--	--
2001	1274	1177	994	832	--	--	--
2002	1427	1260	1018	--	--	--	--
2003	1886	1519	--	--	--	--	--
2004	2129						

The aim of the reserver is to fill in the missing half of the triangle by projecting the pattern of previous years.

A surprising amount can be done by an experienced reserver, just by using simple arithmetic calculations. However, in many of reserving exercises, sophisticated statistical modelling is used involving complicated software, providing highly precise answers. It must be emphasised that these are only mechanical calculations and do not take into consideration the fundamental changes that might be happening to the drivers of the claims. These changes can be:

- inflation rate
- rebuilding costs
- legal framework
- court awards
- medical costs etc.

Wherever possible, the reserver needs to make appropriate adjustments to compensate for these.

Other Triangulations can be created to compare different claims data. For example; loss ratios, case reserves or the number of claims may be plotted against:

1. year reported
2. year the claim was incurred
3. year the policy was written

Each type of plot has its own particular advantages and disadvantages and each is likely to produce a different answer. It is the job of the reserver to try various techniques and produce what he or she considers to be a reasonable answer. Claims reserving never has been and is never likely to be an exact science.

Test Yourself 3

Question 3

The Chain Ladder format is also known as _____________

A. Steps Formulation
B. Triennial Calculation
C. Triangulation
D. Trigonometric

The following checklist for claims reservers, compiled by the Institute of Actuaries in the UK, clearly sums up the whole essence of this complex but vitally important subject.

Checklist for Reservers

a) What historical data are available to the reserver and how far can confidence be placed in its reliability?
b) To what extent is homogeneity of the groups in the risk classification satisfactory?
c) What conclusions have shaped the past experience and what significant changes can be deduced which may affect the future turn out?
d) What methods of projection are proposed, and, are these properly suited to the given circumstances?

(Institute of Actuaries, UK)

3. Examine the premium investment strategies followed by insurance companies

[Learning Outcome c]

With the significant amount of reserving mentioned above, it is imperative that the insurers make their reserves work as hard as possible – this can be shown to be effective globally in that globally, insurers held USD 22.6 Trillion (year end 2009).

With this in mind it is critical that insurers are given an amount of freedom in deciding where to invest their cash without losing some form of monitoring

It is also critical that the insurers have in place specific guidelines and controls for their investment business.
The guidelines should match the insurer's liability constraints as well as the availability of matching investments.

It is appreciated that globally insurers invest in fundamentally different ways, although the guiding principles are the same:

a) Modern Portfolio Theory
b) Asset Liability Management

Definition

Modern Portfolio Theory (MPT)

The fundamental concept behind MPT is that the assets in an investment portfolio should not be selected individually, each on their own merits. Rather, it is important to consider how each asset changes in price, relative to how every other asset in the portfolio changes in price.

Investing is a trade-off between risk and expected return. In general, assets with higher expected returns are riskier. For a given amount of risk, MPT describes how to select a portfolio with the highest possible expected return. Or, for a given expected return, MPT explains how to select a portfolio with the lowest possible risk (the targeted expected return cannot be more than the highest-returning available security, of course, unless negative holdings of assets are possible.)

MPT is, therefore, a form of diversification. Under certain assumptions and for specific quantitative definitions of risk and return, MPT explains how to find the best possible diversification strategy.

However, there are a number of arguments against it:

- financial returns do not follow a symmetric distribution
- correlation between asset classes is not fixed but can vary depending on external events (especially in crises).
- growing evidence that investors are not rational and markets are not efficient

Definition

Asset-liability management

Asset-liability management basically refers to the process, by which an institution manages its balance sheet, in order to allow for alternative interest rate and liquidity scenarios. Banks and other financial institutions provide services, which expose them to various kinds of risks like credit risk, interest risk, and liquidity risk. Asset liability management is an approach that provides institutions with protection that makes such risks acceptable.

Indian Regulations

In India, the insurance premium investment structure is laid down very clearly under the Insurance Regulatory and Development Authority (Investment) Regulations, 2000

Sr. No	Type of Investment	Percentage
i)	Central Government Securities **being not less than**	20%
ii)	State Government securities and other Guaranteed securities including (i) above **being not less than**	30%
iii)	Housing and Loans to State Government for Housing and Fire Fighting equipment, **being not less than**	5%
iv)	Investments in Approved Investments as specified in **Schedule II**	
a)	Infrastructure and Social Sector Explanation: For the purpose of this requirement, Infrastructure and Social Sector shall have the meaning as given in regulation 2(h) of Insurance Regulatory and Development Authority (Registration of Indian Insurance Companies) Regulations, 2000 and as defined in the Insurance Regulatory and Development Authority (Obligations of Insurers to Rural and Social Sector) Regulations, 2000 respectively	Not less than 10%
b)	Others to be governed by Exposure / Prudential Norms specified in Regulation 5	Not exceeding 30%
v)	Other than in Approved Investments to be governed by Exposure / Prudential Norms specified in Regulation 5	Not exceeding 25%

(For further details see http://www.irdaindia.org/regulations.htm)

Test Yourself 4

Question 4

Insurers follow two premium insurance styles: Asset Liability Management and __________

A. Modern Portfolio Theory
B. Modern Profit Theory
C. Multiple Portfolio Theory
D. Multiple Profit Theory

Insurance Accounting

Insurance accounting basics are similar to basics of other forms of accounting. However, there are certain peculiarities that make for specialisations in Insurance Accounting.

The objective of this chapter is not to go into the details of Insurance Accounting; so we shall examine these differences at headline level only.

➢ General Accounting

Items such as the Balance Sheet, Receipts and Payments Account [Cash Flow Statement] and Profit & Loss Account etc. will be in line with the Accounting Standards (AS) issued by the ICAI to the extent applicable to insurers carrying on general insurance business with 3 exceptions. The 3 exceptions are:

(b) Cash Flow Statement to be prepared only under Direct Method
(c) Accounting for Investments is not applicable
(d) Segment Reporting applies to all insurers

➢ Premium

Premium is to be recognised as income over the contract period or the period of risk. Premium received in advance not relating to the current accounting period to be disclosed separately under the head “Current Liabilities”.
Premium reserve for unexpired risks has to be created.
Premium deficiency to be recognised if the expected claim costs and related expenses exceed the related reserve for unexpired risks.

➢ Acquisition Costs

Acquisition costs to be placed in the period in which they are incurred.

➢ Claims

The ultimate cost of claims to an insurer comprises claims under the policies and specific claims settlement costs. Claims under policies comprise the claims made for losses incurred, and those estimated or anticipated under the policies following a loss occurrence. A liability for outstanding claims shall be brought to accounts in respect of both direct business and inward reinsurance business. The liability shall include:
(a) Future payments in relation to unpaid reported claims
(b) Claims Incurred But Not Reported (IBNR) including inadequate reserves [sometimes referred to as Claims

Incurred But Not Enough Reported (IBNER)].
The accounting estimates shall also include claims cost adjusted for estimated salvage value if there is sufficient degree of certainty of its realisation.

➢ Investments

A detailed procedure has been prescribed for determining value of various investments, such as:

a) Real Estate – Investment Property
b) Debt Securities
c) Equity Securities and Derivative Instruments that are traded in active markets
d) Unlisted and other than actively traded Equity Securities and Derivative Instruments

- **Loans**

Loans to be measured at historical cost

- **Catastrophe Reserve**

Catastrophe Reserve has to be created in accordance with the norms, if any, prescribed by the Authority.

Accounting Module

As seen earlier, the basic insurance functions including accounts are carried on at the operating office of the general insurance company. With the reliance now in most companies on IT systems, except for preparation of journal vouchers and few other emerging transactions, all other transactions input to the system can be system generated.

To sum up – the important accounting functions in a general insurance company are:

a) Premium accounting
b) Commission / brokerage accounting
c) Claims accounting
d) Accounting of expenses of management
e) Co-insurance accounting
f) Re-insurance accounting
g) Investment accounting
h) Accounting of foreign operations

Test Yourself 5

Question 5

General Accounting must be in line with which of the following?

A. Accounting Standards issued by the ICAI
B. GAAP Standards Risk
C. International Accounting Standards
D. Insurance Regulatory and Development Authority (Investment) Regulations, 2000

Summary

- Accurate claims reserving is critical for continuing profitability of an insurer
- The interests of the stakeholders are varied – ranging from those of the shareholder, the government, underwriters and the company management.
- There are two main sets of Reserves – premium (unearned premium and unexpired risk) and claims (open claims reserve and IBNR).
- The process of claims reserving is at operational level and its accuracy is critical.
- Insurance companies follow two basic investment theories – Modern Portfolio Theory and Asset Liability Management
- Insurance Accounting – basically the same as other industries but with some differences in view of the way insurance sector works

Some important terms / definitions you have learnt in this chapter

- Technical reserves
- Unearned premium reserve
- Triangulation
- IBNR
- Modern Portfolio Theory

Answers to Test Yourself

Answer to TY 1

The correct option is **B**

Reserves for unexpired risks comes under the Technical Reserves heading

Answer to TY 2

The correct option is **C**

IBNR is Incurred But Not Reported

Answer to TY 3

The correct option is **C**

The Chain Ladder format is also known as Triangulation

Answer to TY 4

The correct option is **A**

Insurers follow two premium insurance styles: Asset Liability Management and Modern Portfolio Theory

Answer to TY 5

The correct option is **A**

General Accounting must be in line with Accounting Standards issued by ICAI.

Self-Examination Questions

Question 1

Mentioned below are some insurance company stakeholders. Which is the odd one out?

A. Underwriter
B. Government / Regulator
C. Shareholder
D. Policyholder

Question 2

If a policy is taken out on June 1st and the Financial Year starts on 1st April; the unearned premium reserve is _________

A. 2/12ths
B. 3/12ths
C. 10/12ths
D. 9/12ths

Question 3

As per premium investment guidelines by IRDA, investment in Central Government Securities should not be less than _____________

A. 20%
B. 15%
C. 10%
D. There are no such guidelines and insurance companies can invest the premium collected the way they want to invest.

Answer to Self-Examination Questions

Answer to SEQ 1

The correct option is **D**

The policyholder is not directly a stakeholder.

Answer to SEQ 2

The correct answer is **A**

2/12ths are what's left of the unearned premium reserve

Answer to SEQ 3

The correct answer is **A**

As per premium investment guidelines by IRDA, investment in Central Government Securities should not be less than 20%.